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THE PRESIDENT'S NEW ANTI-INFLATION PROGRAM

HEARINGS

BEFORE THE

JOINT ECONOMIC COMMITTEE

CONGRESS OF THE UNITED STATES

NINETY-SIXTH CONGRESS

SECOND SESSION

MARCH 17, 20, AND 27, 1980

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THE PRESIDENT'S NEW ANTI-INFLATION PROGRAM

MONDAY, MARCH 17, 1980

CONGRESS OF THE UNITED STATES,
JOINT ECONOMIC COMMITTEE,
Washington, D.C.

The committee met, pursuant to notice, at 2 p.m., in room 318, Russell Senate Office Building, Hon. Lloyd Bentsen (chairman of the committee) presiding.

Present: Senators Bentsen and Sarbanes; and Representatives Bolling, Reuss, Brown, and Rousselot.

Also present: John M. Albertine, executive director; Louis C. Krauthoff II, assistant director-director, SSEC; Charles H. Bradford, minority counsel; Kent H. Hughes, Mary E. Eccles, L. Douglas Lee, William R. Buechner, Lloyd C. Atkinson, and Mayanne Karmin, professional staff members; Betty Maddox, administrative assistant; and Stephen J. Entin and Mark R. Policinski, minority professional staff members.

OPENING STATEMENT OF SENATOR BENTSEN, CHAIRMAN

Senator BENTSEN. This hearing will come to order, gentlemen, if you would give the witness a little room here.

This is the first in a series of hearings the Joint Economic Committee plans to hold on President Carter's new proposals for controlling inflation. Our first witness this afternoon is the Honorable Charles Schultze—not George—Chairman of the Council of Economic Advisers.

The President's proposals have come none too soon. The inflation situation in this country is dangerously close to being out of control. I don't know when I have been as concerned about the economic future of my country as I am today. Consumer prices rose at an annual rate of 18 percent in January. Producer prices rose at a rate of almost 20 percent during the first 2 months of this year.

Now, the President's five-step program is a good step in the right direction, and it is a useful and a welcome framework for waging an effective battle against inflation. And I, for one, am going to support the President in trying to implement the program. But I have no illusions about how difficult it is going to be to get a balanced budget. My phones are already ringing off the walls, and I know that all of the lobbyists in Washington have their computers going now to alert their particular constituency to write letters, to call us on the phone, to call on us, yes, to bring about a balanced budget, to make the cuts—but not to cut their particular program because that one is different.

It is going to be a real test for the Congress. We are going to have to convince the American people that the Congress has the discipline and the tools and the will to bring about that balanced budget.

My major disappointment, though, in the President's announcement was the lack of specific proposals for revitalizing American productivity, to make us competitive on world trade, to encourage exports in a more aggressive manner in the trade markets.

Mr. Carter's—the President's—proposals are aimed at cutting inflation in the short run, but they will be effective only if they go hand in hand with long-run measures as well. Later on in your testimony I would hope that you would comment on that.

I would now yield to my distinguished colleague, vice chairman of the committee, Congressman Bolling.

Representative BOLLING. Thank you, Mr. Chairman. I think I will pass.

Senator BENTSEN. The ranking minority member who is here, Congressman Brown.

Representative BROWN. Here and out of breath, Mr. Chairman.

OPENING STATEMENT OF REPRESENTATIVE BROWN

Mr. Chairman, the President's latest anti-inflation program calls for increased tax burdens on our citizens and will guarantee the recession we have been hoping to avoid. The President's program blames the whole world for inflation and makes the public and the United States the fall guy for the cure. At a time when workers' incomes are already being drastically reduced by inflation and record-high taxes, the President proposes more taxes that will reduce these incomes even more.

We already face tax increases of $30 billion and $70 billion in 1980 and 1981, because of inflation pushing people into higher tax brackets, because of social security tax increases enacted by the Congress, and energy tax increases. Any new taxes are wholly unreasonable.

The President's new tax on oil imports will cost the consumer 10 cents a gallon more at the pumps. The withholding of taxes on interest and dividends takes money out of the bank accounts of every American saver—those that have any savings left, because they have been dipping into savings at record rates to survive as consumers.

Once again President Carter is telling the American people that they must bear the brunt of his efforts to lower the inflation—an inflation that he has been largely responsible for creating. The recession will be caused by increased tax measures. Credit restraints, shutting consumers off from credit resources and declines in profits and real incomes.

As for credit controls, the only credit control that we need in this country should be put on the Federal Government. It should balance its budget, of course, if it can; cut its off-budget borrowing; and get out of the credit markets. This is essential to lower interest rates for consumers, businesses, and homebuilders alike.

Concerning the President's proposal to cut only $13 billion to $14

billion off Federal spending in fiscal 1981, the cuts are only half large enough, in my opinion, to get the job done of balancing the budget, because you are going to see some off-budget items come on budget, I think, as this year progresses. Is President Carter telling us that there is only $13 billion in waste in a $600 billion budget? Why can't he cut enough to give us tax reductions instead of tax increases?

I support the chairman in my grave concern that this particular proposal does not stimulate the expansion of our economy. Why must we wait always until "next year" for those tax cuts? Instead of raising taxes and making cosmetic cuts in the budget, the President should make budget cuts large enough to end Government borrowing, lower interest rates, and make room for growth-inducing, inflation-fighting tax cuts.

We need personal tax cuts and faster depreciation aimed at stimulating savings and investment. These tax cuts would fight inflation by putting more goods on the shelves. They would keep the economy moving forward so we could fight inflation without unemployment.

Furthermore, there are not enough specifics for us to really make a good judgment. Why can't we see them until April? Why, after a full month of crisis and right after a full-scale budget submission, does the President need yet another 2 weeks to figure out what is in the budget and where to cut it? Those will be some of the questions I will be asking.

Senator BENTSEN. Thank you.

Congressman Reuss.

Representative REUSS. No, thank you, Mr. Chairman.

Senator BENTSEN. Senator Sarbanes.

Senator SARBANES. Mr. Chairman, I am anxious for Mr. Schultze to get on with his presentation and for the administration to get on with the implementation of the program they have put forward, some of which will require congressional response and some of which will not.

But the President has charted a course now for his administration, and I think it is important that they proceed in an expeditious manner before everyone can descend upon them from all different directions and proceed to try and tear things apart.

And I assume Mr. Schultze will sketch out for us today a timetable on which they intend to go forward. That would be very helpful.

You think you are on course, and you have charted a course, and you ought to sail on it and give those who have to interact with you a chance to respond and make their judgments as these things come along. But I think you have to keep moving. I see everyone, you know, is now descending on you. Some say it is too hard; others say it is too soft: "You didn't do this. You did this. You didn't do that," and so forth and so on. So, I am anxious to hear Mr. Schultze, and particularly the plans that they have for carrying forward so we can get some decisions made.

Senator BENTSEN. Mr. Schultze, I for one want to thank you for the incredible amount of effort that you have put in, and your associates, in trying to work with the various Members of the Congress in getting input to try to put together a program that would be successful. Now we will be pleased to hear from you.

STATEMENT OF HON. CHARLES L. SCHULTZE, CHAIRMAN, COUNCIL OF ECONOMIC ADVISERS

Mr. SCHULTZE. Thank you, Mr. Chairman.

I would like to reciprocate by stating that I have been at this kind of work off and on for the last, oh, give or take a little bit, maybe 15 years, not as much as perhaps others, but for a while. And I don't think I ever witnessed anything to compare with the kind of cooperative work that went on between the administration and the Congress over this past 2 weeks. And while I am sure there are going to be points of specifics on which we disagree, I have found the common elements that bind us together in those kinds of conferences turned out to far, far greater than the areas of disagreement that I think we may be going to have around the edges.

And so, if I might, Mr. Chairman, what I would like to do is, first, submit for the record a set of documents which spell out the President's program and the actions taken by the Federal Reserve, under its own authorities and under those granted to it by the President under the Credit Control Act of 1969. That would be the President's speech in which he laid out his program; a fact sheet which we prepared that summarizes the major actions; the Federal Reserve press release dated March 14, 1980, which, in turn, summarizes the Federal Reserve actions; an outline of the Federal Reserve's voluntary special credit restraint program; and the specific regulations issued by the Fed last Friday.

I think these might be useful to the committee, and I request they be put in the record.

Senator BENTSEN. Without objection, that will be done.

[The information referred to follows:]

EMBARGOED FOR RELEASE
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MARCH 14, 1980.

Office of the White House Press Secretary

THE WHITE HOUSE

TEXT OF THE PRESIDENT'S
ADDRESS ON ECONOMIC POLICY

The East Room

Persistent high inflation threatens the economic security of our country.

Since my economic and budget reports in January, rapid changes in world events and economic prospects have made it necessary to intensify our anti-inflation fight.

In the last eight weeks, interest rates have surged to unprecedented heights and inflation has sharply intensified.

This is a worldwide problem. During the last two reporting months, the increases in the wholesale price index in Japan, Great Britain and Italy have all exceeded an annual rate of 25 percent. Even in West Germany the inflation rate in wholesale prices was 13 percent.

The inflation we face today is deeply rooted. Its many causes have built up over more than a decade. The most important of these causes are soaring world oil prices, declining productivity growth and our failure in government, as individuals, and as a society to live within our means.

Inflation is a symptom of economic distress. The truth is that we have inflation because our economy is not productive enough to do all the things we demand of it. We want it to give us higher incomes, bigger profits and bigger government programs in our favorite area.

The federal government must stop spending money we do not have and borrowing to make up the difference.

Our whole society -- the entire American family -- must try even harder to live within its means. As individuals and as a nation, we must begin to spend money according to what we can afford in the long run -- not according to what we can borrow in the short run.

There are no quick answers to inflation and above all no painless answers. If there were any such solutions, they would have been implemented long ago. We cannot abolish inflation overnight by just passing a law against it. Only a long-term effort -- with the partnership of business and labor, individual citizens and all branches and levels of government -- can succeed in bringing this problem under control.

This dangerous situation calls for urgent measures. We must act firmly and decisively. We must act now. We must remove any doubt about this nation's will to take the painful steps needed to control inflation. We cannot accept high rates of inflation as a permanent fact of life.

The intensive anti-inflation program I am announcing today involves five major components:

-- First, discipline by reduction in the federal budget.

-- Second, discipline by restraints on credit.

-- Third, discipline by wage and price actions.

-- Fourth, discipline by greater conservation of energy.

-- Fifth, structural changes to encourage productivity, savings, and research and development.

Let me discuss them one by one.

First, the budget.

I will soon set forth a revised budget for fiscal year 1981 -- which begins on October 1 of this year. It will be a balanced budget, and I intend to keep it in balance.

Since the last balanced budget 12 years ago we have added almost one-half trillion dollars to our national debt. In 1981 we will thus achieve an objective that has almost always eluded our country -- in good times and bad -- a balanced budget.

By the end of this month, I will send to the Congress a major revision in both my 1980 and my 1981 budgets.

I will propose significant reductions of budget authority from the current budget, in order to cut spending this fiscal year and next.

I will cut spending in the 1981 budget by more than $13 billion. To reach that goal, I will:

-- Defer, reduce or cancel most of the new or expanded programs that were originally proposed in the 1981 budget.

-- Cut expenditures for personnel, operations and maintenance throughout the government.

-- Freeze federal civilian employment immediately, and maintain rigid ceilings so that by the end of October of this year we will have 20,000 fewer federal employees.

-- Reduce ongoing spending programs throughout the federal government.

I urgently request from the Congress the savings and revenue measures in the budget I submitted in January. I want to stress particularly the legislation needed to hold down hospital costs, to reform federal pay, and to speed up collections of revenue.

When budget cuts demand sacrifices from many Americans, it is intolerable for some to evade prompt payment of taxes. I will send to the Congress legislation to make sure that taxes that are owed on interest and dividends are actually paid, and paid in a timely manner.

I will maintain my commitment to a strong defense and to the level of real growth in defense spending which we pledged to our NATO allies. But the Defense Department will not be immune from budget austerity. In particular, I will require that the Department make savings that do not affect our military readiness. I consider the proposed defense budget adequate to meet our nation's needs. We must maintain budget restraint and fiscal responsibility in all government agencies.

Based on our estimates of economic and budgetary developments, the actions I have described will produce a balanced budget in 1981.

In our system, Congress controls the power of the purse. The recent intense efforts of the Congressional leaders and my close consultation with them have convinced me that the Congress will indeed enact and maintain a balanced budget, as I am recommending. But to ensure that outcome I will use every power at my command:

-- As I did last week on a popular bill, I will veto any legislation that exceeds the spending limits consistent with a balanced budget.

-- I will use my full powers under the 1974 Budget Reform Act to hold down federal spending, including some expenditures which have previously been authorized.

-- If during the course of the year I judge that these actions and powers are not sufficient, I will ask the Congress for a temporary grant of extraordinary powers to ensure that spending is contained.

Cutting back federal spending to match revenue is not a cure-all -- but it is an essential first step. The sources of inflation are far too complex to be treated by a single remedy. But nothing will work until the federal government has demonstrated that it can discipline its own spending and borrowing -- not just as a one-year exercise, but as a long-term policy. Together, we will do just that. We will dispel the notion that deficits will always be with us.

I want to be absolutely honest about these budget cuts. We have been cutting out waste and fraud and trimming the bureaucratic fat. But this time, there will also have to be cuts in good, worthwhile programs -- programs which I support very strongly.

In this critical situation we must all look beyond some of our most worthwhile immediate aims to be the overriding permanent needs of the whole nation.

Our second area of action is restraining the growth of credit.

Just as our governments have been borrowing to make ends meet, so have individual Americans. But when we try to beat inflation with borrowed money, we just make the problem worse.

Inflation is fed by credit-financed spending. Consumers have gone into debt too heavily. The savings rate in our nation is now the lowest in more than 25 years. As inflationary expectations have worsened, businesses and other borrowers are tempted to use credit to finance speculative ventures as well as productive activities.

The traditional tools used by the Federal Reserve to control money and credit expansion are a basic part of the fight on inflation. But in present circumstances, those tools need to be reinforced so that effective restraint can be achieved in ways that spread the burden reasonably and fairly.

I am therefore using my power under the Credit Control Act of 1969 to authorize the Federal Reserve to impose new restraints on the growth of credit on a limited and carefully targeted basis. Under this authority the Federal Reserve will:

-- Establish controls for credit cards and other unsecured loans but not for secured loans on homes, automobiles, and other durable goods.

-- Restrain credit extensions by commercial banks that are not members of the Federal Reserve System and by certain other money-market lenders.

The Chairman of the Federal Reserve will announce a voluntary program, effective immediately, to restrain excessive growth in loans by larger banks and other lenders. At the same time, the program will encourage the flow of available credit supplies for investment and other productive uses. Special attention will be given to the particular needs of small businesses, farmers, and homebuyers. I support these initiatives by the Federal Reserve.

These carefully targeted actions will not damage the productive capacity of our nation. By helping to curtail excessive uses of credit and dampening inflation, they should -- along with the budgetary measures I announced -- speed prospects for reducing the strains in financial markets.

In addition, I am taking steps to reduce the extension of credit by the federal government. Federal loans and loan guarantees will be cut by nearly $4 billion in fiscal 1981.

As a longer-run measure, I urge Congress to institute the credit budget I proposed in January. It will help us control more effectively the loans and loan guarantees provided by the federal government.

Our third area of action is the voluntary wage and price standards.

I do not have authority to impose controls. I do not seek that authority. We will not impose mandatory wage and price controls. Government wage and price controls have never worked in peacetime. They create unfair economic distortions and hurt productivity. These results always force price controls first to be eased and then dismantled -- while inflation roars ahead.

Controls create inequities -- and the greatest inequity is their effect on the average family. As even the most ardent advocates of mandatory controls concede, the cost of vital necessities such as food and fuel would be passed on to those living on frozen wages and fixed incomes.

We cannot outlaw inflation with a massive federal bureaucracy, or wish it away with magic formulas.

On the other hand, voluntary wage and price standards offer the flexibility we need to deal with our complex economy.

The Council on Wage and Price Stability has just issued revised pay standards and confirmed an extension of the price standards.

The new pay standards were developed from the recommendation of a Tri-Partite Advisory Committee, with members from business, labor and the public. The Committee unanimously recommended standards for pay increases in the range of 7-1/2 to 9-1/2 percent, and stated that under normal circumstances increases should average 8-1/2 percent. I am determined to meet that goal.

In the fact of last year's 13 percent increase in the consumer price index, and the even higher rate of recent months, this unanimous recommendation of the Pay Advisory Committee -- designed to produce an average wage and salary increase of 8-1/2 percent -- reflects a commendable spirit of restraint and cooperation. With business, labor and public support, we can meet this goal of restraint.

I am sharply expanding the price and wage monitoring activities of the Council on Wage and Price Stability. Its current staff of 80 people will be more than tripled. The Council will establish teams of experts to track wage and price developments in each major industry. The Council will meet with leaders from specific industries to secure their cooperation. Where necessary, we will ask large firms for pre-notification of significant price increases. We will investigate wage and price increases that seem out of line with the standards. I mean to apply those standards with vigor and toughness to both business and labor.

Our fourth area of action is energy.

The plain truth is that we will never be completely strong at home or secure abroad until we have at last solved our nation's excessive dependence on foreign oil.

The price of imported oil has more than doubled in the last 12 months. Last year's increase alone was greater than all other increases combined since the oil embargo of 1973.

We must forge ahead toward the goal I set last July -- cutting in half the amount of oil we import by 1990. To do this will require increased production of domestic oil, natural gas and coal -- unrelenting efforts for conservation -- and the rapid development of alternative energy sources.

For three years I have fought for a national energy policy to achieve each of these goals. Today, at long last, we are close to enacting such a policy into law. We must not falter now.

I am asking the Congress to finish without delay the three essential pieces of the energy program -- the Windfall Profits Tax, the Energy Security Corporation, and the Energy Mobilization Board. These bills are cornerstones for our energy security, our national security, and our fight against inflation.

I have recently submitted a proposal to Congress to conserve energy in electric power plants and to convert them from oil to coal and other fuels. This too must be passed promptly.

But we can never solve our energy dependence unless we meet the problem of extravagant gasoline use.

Gasoline is the most important and most wasted petroleum product in the United States. It accounts for some 40 percent of all the petroleum we use. In almost every other industrial country, the average amount of gasoline used by each citizen is much lower than ours, and the average price is much higher. Americans have done well in the past year in gasoline conservation. But if we are going to reduce further our dependence on foreign oil, we must do more.

Therefore, I am exercising my Presidential authority to impose a gasoline conservation fee on imported oil. This will be applied solely to gasoline in an amount equal to about 10 cents a gallon. The fee will not add to the cost of any other oil product. It will not add to oil company profits. It should reduce imports by 100,000 barrels a day by the end of a year, and later by as much as 250,000 barrels per day.

I will submit to Congress a request for a specific gasoline tax which will replace the conservation fee.

The funds from the gasoline conservation charge will be held in reserve or used to reduce the national debt. I do not intend to use these revenues to balance the budget or as a substitute for necessary spending cuts. But these revenues, which will begin accruing immediately, will give the budget a margin of safety -- ensuring that it remains in balance even if conditions or estimates change.

We can now set new targets for gasoline consumption nationwide which will reduce consumption by 400,000 barrels per day.

This action also underscores a commitment to greater conservation that our friends abroad -- both producing and consuming nations -- can join and support.

Finally, the Secretary of Energy is pursuing an intensified national energy conservation plan. Our aim is to involve every level of government, business, labor -- in fact, every single citizen -- in conserving American energy.

Our fifth area of action involves long-term structural changes to encourage productivity, savings, and research and development.

We have already begun to make progress in reforming government regulations which interfere with these goals. Since taking office, I have worked to root out unnecessary government regulations and to make cost-effective those which are necessary. I urge the Congress to pass the Regulatory Reform Act, which will strengthen our efforts.

As much as possible, we need to let the private enterprise system be free to compete. We have succeeded in deregulating airlines. I urge the Congress to speed passage of comprehensive bills to cut regulation of banking, trucking, railroads and communications.

We must also encourage savings. The single most important way we can do that is to phase out the ceilings that limit the return most small savers can earn. A financial institutions reform bill which makes this change has just been approved by a House-Senate Conference Committee. I urge its quick passage.

We must face the fact that over the last 10 years the pace of productivity growth in our country slowed sharply. Last year it actually declined.

This trend is an important long-term factor in inflation. It must be reversed.

I am asking my Presidential Commission on an Agenda for the 1980s as part of their work to develop specific recommendations for revitalizing our economy.

Our priority now is to balance the budget. But once these spending limitations have actually been achieved, we can then provide tax relief to encourage investment. Through fiscal discipline today, we can free up resources tomorrow for the productivity improving tax reductions our nation needs.

This discipline will not be easy. Our new budgets will be very tight. There are some things we cannot afford -- at least not now. But the most important thing we cannot afford is the national delusion we have been harboring about inflation. We cannot afford the fairy tale that inflation can be passed on to the next person -- or to the next generation.

The actions I have outlined involve costs. They involve pain. But the cost of acting is far less than the cost of not acting. The temporary pain of sacrifice and discipline is far less -- for all of us together -- than the still worse permanent pain of rising inflation. For all of us, but especially for the most needy, inflation is indeed the most cruel tax of all.

If we take these necessary steps against inflation, it will not result in a quick victory. Over the next several months, inflation is likely to continue at a high level. We must be patient and persistent.

I am confident that with the steps I am proposing today, the inflation rate will be declining later this year. As that happens, we may look forward to calmer financial markets and lower interest rates.

By taking control of this problem -- which involves taking control of ourselves -- we can put an end to the fear about the future that afflicts so many of our people and institutions.

In the fight against inflation, what is at stake is more than material wealth or material comfort. What is at stake is whether or not we Americans -- as a nation, as a people -- will control our own destiny.

In crises abroad, we have always shown our ability to respond with steadfastness and courage. We must now show the same determination in meeting the challenge of inflation.

With inflation, as with defense and energy, our responsibility is clear:

-- to face the world as it is, and to be honest about the hard decisions that are necessary;

-- to make those decisions and to carry them out; and

-- to build together a strong and secure and hopeful future for every American.

With proper discipline we will prevail in our fight against inflation.

EMBARGOED FOR RELEASE ON DELIVERY
OF THE PRESIDENT'S SPEECH

MARCH 14, 1980

Office of the White House Press Secretary

THE WHITE HOUSE

ANTI-INFLATION PROGRAM

The President's anti-inflation program announced on March 14, 1980 involves five major parts:

(1) Increased Discipline in the Federal Budget
(2) Restraints on Credit
(3) Wage and Price Actions
(4) Greater Energy Conservation
(5) Economic Structural Changes to encourage productivity, savings, research and development.

Increased Discipline in the Federal Budget

In light of recent increases in the rate of inflation, the President has decided that it is necessary to balance the budget in FY 1981.

The FY 1981 balanced budget is achieved through:

--deferral, reduction or cancellation of most of the new or expanded programs originally proposed in FY '81 budget;
--a cut in expenditures for personnel, operations, and maintenance throughout the government;
--an immediate freeze in Federal civilan employment, and rigid maintenance of employment ceilings to ensure that there will be 20,000 fewer Federal employees by the end of 1980 than there are now;
--a reduction in ongoing spending programs throughout the Federal government;
--placing on an urgent basis the need to pass the savings and revenue measures submitted in the January budget, including hospital cost containment, Federal pay reform and cash management reforms;
--legislation to be sent to Congress authorizing withholding of interest and dividend payments in order to ensure that Federal income taxes owed on those interest and dividend payements are in fact paid;
--requiring the Defense Department, through efficiencies and savings that do not affect military readiness, to offset a large part of the cost increases the Department now faces;
--a commitment to veto any legislation that exceeds the spending limits consistent with a balanced budget;
--commitment to use the powers under the Budget Reform Act of 1974 available to the President to defer or rescind Federal spending;
--a willingness to seek from the Congress, if adequate steps are not being taken to achieve a balanced budget, a temporary grant of extraordinary powers.

Restraints on Credit

A. The President is using power granted him under the Credit Control Act of 1969 to authorize the Federal Reserve to impose new restraints on the growth of credit on a limited and targeted basis:
--Controls will be authorized for consumer loans other than those for homes, automobiles and other durable goods;
--Authority will be authorized to restrain credit extensions by commercial banks which are not members of the Federal Reserve System and by certain other money market lenders.

B. The Federal Reserve will announce a voluntary program, effective immediately, to restrain excessive growth in loans by large banks and other lenders.

C. Federal loans and loan guarantees will be cut by $4 billion in Fiscal 1981.

D. The President renewed his commitment to seek Congressional passage of a credit budget to enable the Federal government to control the loans and loan guarantees it provides more effectively.

Wage and Price Actions

A. Reaffirmed absolute opposition to wage and price controls.

B. Acceptance of pay standard recommendations of the Pay Advisory Committee -- standards which permit pay increases in the range of 7.5 to 9.5 per cent, with an average under normal conditions of 8.5 per cen large firms with settlements over the 8.5 per cent midpoint will be asked to report to the Council on Wage and Price Stability (COWPS) with supporting information.

C. Continuation of the price standard established in final form by COWPS on November 1, 1979.

D. Lowering of the threshold for regular, formal reporting of price change information to COWPS from companies with $250 million or more in sales to those with $100 million or more in sales.

E. Selective prenotification of price increases by large firms, on a voluntary basis.

F. Increased COWPS staff to expand monitoring effort.

Greater Energy Conservation

A. Renewed appeal to the Congress to complete work on the Windfall Profits Tax, the Energy Security Corporation, and the Energy Mobilization Board and to take prompt action on the recently proposed coal conversion legislation.

B. Imposition of a gasoline conservation fee on imported oil of $4.62 a barrel, which will be applied solely to gasoline in an amount equal to about 10 cents a gallon.

C. Submission to Congress of a motor fuels tax designed to replace the gasoline conservation fee.

D. Establishment of new targets for nationwide gasoline consumption at a maximum of 7 million barrels per day, or a 5.5 per cent decrease from 1979 level.

E. Development of intensified national energy conservation plan by the Secretary of Energy.

Long-Term Economic Structural Changes

A. Renewed appeal to Congress to enact the Regulatory Reform Act and comprehensive legislation to deregulate the banking, trucking, railroad and communcations industries.

B. Renewed appeal to Congress to enact the Financial Institutions Reform Act, which will gradually lift the ceilings that limit the return most small savers can earn.

C. A request that the Presidential Commission for a National Agenda for the Eighties develop specific recommendations for revitalizing our economy's productivity.

D. Statement of intention to propose tax measures to spur productivity once the task of balancing the budget and assuring overall fiscal discipline is achieved.

More detail on the following items of the President's program is set forth below:

(1) Overview of the Inflation Situation
(2) Budgetary Actions/Hiring Limitation
(3) Pay and Price Standards
(4) Gasoline Conservation Fee
(5) Motor Fuels Tax
(6) State Gasoline Targets
(7) Withholding of Interest and Dividends

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More detailed information on credit restraints will be set forth in a separate release provided by the Federal Reserve.

OVERVIEW OF THE INFLATION SITUATION

We have just come out of a decade of economic turmoil; a decade which saw

-- a tenfold increase in the price of oil,
-- a twenty-fold increase in the U.S. oil import bill,
-- the deepest recession in 40 years,
-- inflation which averaged eight per cent over the whole decade, and
-- a sharp slowdown in productivity growth.

Thus as we enter the 1980's, economic policy has to concentrate on three major priorities:

(1) reducing inflation,
(2) adjusting to a world of sharply higher energy prices and reducing our vulnerability to OPEC price and supply decisions, and
(3) improving the efficiency and productivity of our economy.

In recent weeks this first priority has become even more important. Citizens across the country have become worried that our economy is out of control. This worry affects their expectations about inflation and thus their behavior.

There are real causes for concern.

-- The early months of 1980 have seen another explosion in energy prices and the passthrough of increased energy costs in other good and a wholesale price index rising at an annual rate of 20 per cen

-- Interest rates are skyrocketing; and

-- The bond market is in disarry.

Strong and decisive action is necessary to turn the tide around. We cannot let a continued worsening of inflationary expectations and an erosion of confidence undermine a basically sound economy.

What caused this worsening of inflationary expectations? A number of things:

Our economy has shown greater strength than expected. The widely-expected recession has not materialized.

-- Retail sales have remained strong as consumers continued to hold down their savings rate to spend;
-- Employment is still up and the unemployment rate is steady at roughly six per cent;
-- Restraint in financial markets has not bit deeply except in housin
-- Strong markets have made it easier for businesses to raise prices.

Inflation has accelerated sharply.

-- In January and February the Producer's Price Index increased at an annual rate of about 20 per cent;
-- In January the CPI increased at the rate of 1.4 per cent (an annual rate of 18 per cent),
-- These dramatic increases come from another round of energy price increases (7.5 per cent in February alone), from the passthrough of energy price increases into the prices of goods made with and transported with energy, and from the passthrough of other costs swallowed last year.

Misinterpretation of the budget.

-- The increase in nominal expenditures for FY 1980 between January 1979 and January 1980 was a result of inflation -- but it was perceived by some as backing away from the commitment to fiscal restraint;

-- The $16 billion deficit in the 1981 budget was not widely recognized as being a result of the administration's forecast of a weak economy. (With a six per cent unemployment rate, the budget proposed in January would be in surplus.)
-- Concerns about a defense boom.

And, finally, concern about the growth of money supply and business loans.

BUDGETARY ACTIONS

Throughout his administration, the President has emphasized the need for fiscal restraint. Given the recent increases in our nation's rate of inflation, he has determined that a balanced budget in FY 1981 is imperative.

To implement this decision, the President will place before the Congress a package of substantial expenditure cuts in almost every major program area not vital to national security. These cuts are real, and have been allocated fairly. The President recognizes the sacrifice he will be asking people to make through these reductions. However, he has decided that balancing the budget now is a major step toward restoring confidence in our economy.

Budget Totals

When submitted in January, the FY 1981 budget had a projected deficit of about $16 billion. Since January, changes in the economic outlook and technical revisions have combined to raise both outlays and revenues for FY 1981, narrowing the FY 1981 deficit by a small amount (about $2.3 billion).

The President's proposed expenditure cuts will bring the budget to balance. Beyond that, the imposition of a measure to reduce gasoline consumption and oil imports, and the proposal to apply withholding to existing taxes on interest and dividends (a measure to reduce tax evasion) will together generate new revenues of about $14 billion, providing an overall surplus for the budget.

The budget estimates are as follows:

	1980	1981
I. OUTLAYS (in billions)		
January Budget	564	616
plus: revisions	6	9 to 10
less: budget cuts	-2	-13 to -14
equals: revised outlays	568 to 569	611 to 613
II. REVENUES (in billions)		
January budget	524	600
plus: revisions	5	11 to 12
Withholding on Interest and Dividends	0	3
Contingency Allowance (Revenues from gasoline conservation fee)	(3)	(10)
equals: revised revenues	529	614 to 615
(including contingency allowance)	(532)	(624 to 625)
III. DEFICIT (-) OR SURPLUS (+) (in billions)		
January budget	-40	-16
Revised estimate	-39 to -40	0 to +3
(Contingency allowance)	(+3)	(+10)
Revised estimate after contingency	(-36 to -37)	(+10 to +13)

Proposed Spending Cuts

The President will propose reductions in virtually every area of the budget to eliminate the deficit in FY 1981. He will defer less essential spending. He will rescind budget authority in 1980. He will propose reductions in appropriations for the FY 1981 budget. He will seek legislative reforms lowering expenditures. The President intends to use fully the authorities he has at hand to achieve budget balance.

These recommendations are the product of an unprecedented joint effort with the Congress. The President's senior advisors and members of Congress have identified and reviewed the actions which are necessary to balance the 1981 budget. There is substantial agreement concerning specific reductions in major programs and in the general pattern of reductions in other areas.

Both the Administration and the Congress intend to work closely together to see these proposals enacted.

Reductions in New Initiatives

The President has decided to eliminate, reduce or postpone many of his new initiatives. Among those initiatives affected are:

	Outlay Reductions 1981 (in millions)
New EDA development financing program (DOC)	212
Solar and Conservation Bank (HUD)	76
Territorial Tax Matching (DOI)	22
The State Share of General Revenue Sharing (Treasury)	1,700
Welfare Reform Initiatives (DOL, HHS)	859
Mass Transit Capital Grants (July energy program)	265

The budgetary proposals will also include substantial cuts in numerous on-going programs virtually across the government. Selected examples are:

Operating and administrative expenses (all agencies)
Water and sewer grants and loans (USDA)
Agricultural Conservation Program (USDA)
Foreign Aid (AID, Treasury)
Coastal Energy Impact Fund (DOC)
Water project construction (Corps of Engineers, USDA)
Energy Impact Assistance (DOE)
Mental Health and Alcohol Services (HHS)
Health Services Grants (HHS)
Rehabilitation Loan Program (HUD)
Land and Water Conservation Fund (DOI)
Urban Park Grants (DOI)
LEAA (DOJ)
Welfare Reform Demonstration Project (DOL)
Public Service Employment (State)
UN Voluntary Contribution (State)
Coast Guard facilities (DOT)
Airport programs (DOT)
Highway construction (DOT)
Waste Treatment Construction Grants (EPA)
Facilities construction (NASA)
Space Science (NASA)
Facilities construction (VA)
Export Loans (ExIm Bank)
Business Loan and Investment Fund (SBA)
Applied Research (NSF)

The details concerning reductions in these and other federal programs will be made public along with the budget revisions at the end of this month.

Executive Branch Hiring Limitation

The limitation on Executive Branch hiring will take effect immediately and its duration is indefinite.

Agencies are restricted in filling full-time permanent positions to no more than 50 per cent of vacancies that occur after February 29, 1980. Vacancies that existed prior to that date may be filled, but only by using the allowed 50 per cent of vacancies occurring after February 29.

For purposes of illustration, a 50 per cent hiring limitation will result in a reduction of 6,500 full-time permanent positions per month. Over a 90-day period, this would mean that about 19,500 vacancies would not be filled, producing savings of up to $57 million.

PAY AND PRICE STANDARDS

Pay Standard for Second Program Year

The Pay Advisory Committee's recommendation for a 7.5 per cent to 9.5 per cent range of permissible increase has been adopted as the second year pay standard under the voluntary program.

Although the Administration has adopted a range rather than a single standard, it is expected, nonetheless, that wage settlements nationwide will average about the midpoint of the range, 8.5 per cent.

All businesses with more than 1,000 employees that settle on pay increases above 8.5 per cent will be asked to report such settlements to the Council on Wage and Price Stability, along with supporting statistical information.

The Pay Advisory Committee's recommendation for a second year 7.5 per cent Cost of Living Adjustment evaluation has been adopted.

Price Standard for Second Program Year

The price standard for the second program year issued in final form by the Council on Wage and Price Stability on November 1, 1979, will be continued.

Intensified and Expanded Pay and Price Monitoring

The threshold for regular (quarterly), formal reporting of price change information to the Council on Wage and Price Stability will be lowered from companies with $250 million or greater in annual sales to companies with $100 million or greater in annual sales. This will more than double the number of business firms intensively monitored by CWPS (from about 1200 to about 2500).

Pre-notification of price changes will be selective -- where it appears to be needed and makes sense. There will be no standard requirement for pre-notification by all businesses that are affected by the regular reporting requirement.

Expansion of the Council on Wage and Price Stability

The staff capability of the Council on Wage and Price Stability will be more than doubled to administer the intensified program. Most of the added people will support price and pay monitoring activity. Audit capability will be added. Price monitoring will be greatly strengthened. Initial review time will be reduced; CWPS will evaluate exceptions requests faster and reduce decision time.

GASOLINE CONSERVATION FEE

Nature of Fee

The fee will be $4.62 per barrel on imported crude oil. The cost of this fee will be shifted entirely to the production of gasoline. The expected effect of the fee on gasoline prices will be about 10 cents a gallon. Imports of gasoline will also be subject to a charge, equal in amount to the expected average impact of the fee on gasoline of 10 cents a gallon, or $4.20 per barrel.

The conservation fee is temporary; the President will submit to the Congress legislation to establish a tax on motor fuels. When that tax is enacted the fee will be removed. Such tax legislation would have the same favorable effect of reducing petroleum imports but would eliminate the need for the complex administrative regulations to shift the cost of the import fee to gasoline.

The fee is effective for gasoline produced or imported and crude oil imported after 12:01 a.m., March 15, 1980. A Presidential Proclamation providing the framework for the detailed mechanisms of the plan will be issued in the next few days, effective March 15, 1980.

These actions are taken under authority of Section 232(b) of the Trade Expansion Act, and of the Emergency Petroleum Allocation Act (EPAA). The Trade Expansion Act gives the President authority to take action to adjust levels of imports that threaten national security. Such adjustments can be made through the imposition of an import fee, and the establishment of a program to shift the fee to gasoline. The EPAA provides the President with authority to impose price and allocation controls on crude oil and refined products.

In accordance with the Trade Expansion Act, the Secretary of the Treasury conducted an investigation last year into the Nation's dependence on oil imports and concluded that the levels of such imports threaten national security.

Shifting the entire cost of the fee to gasoline will focus the fee on the product which provides the greatest conservation potential without unduly affecting the economy. The expected effect of the conservation fee followed by the motor fuels tax, is to reduce gasoline and diesel consumption and imports by approximately 100,000 barrels a day by the end of the first year, and up to 250,000 barrels by the end of the third year.

The fee will raise the price of gasoline by about 10 cents per gallon, effective May 15, 1980. The direct effect of this increase will raise overall consumer prices by about 1/2 percentage point. The majority of this increase will be reflected in the CPI during May and June. Over the following year additional (but much smaller) indirect effects will be felt elsewhere in the economy, as gasoline costs are passed on. In total, these direct and indirect effects will increase the CPI by about 3/4 of one percentage point.

There are certain offsetting factors, however. To the extent we can reduce our appetite for imported oil and bring supply and demand into balance, pressure on OPEC to raise prices will decrease. This fee will not only produce additional demand restraint, it demonstrates the willingness of the United States to make sacrifices to curtail gasoline use. This is an important element in securing the international cooperation that is vital if we are truly to bring the oil price explosion under control.

The program will not cause the price of uncontrolled domestic crude oil to rise, since the entitlements program will shift the entire fee to gasoline producers and reimburse crude oil importers to the extent that they do not produce gasoline.

The measure will also increase federal revenues by just over $10 billion annually.

How the Cost of the Fee Will be Shifted from Crude Oil Imports to Gasoline Production

The entire burden of the crude oil import fee will be shifted from importers to gasoline producers. This will be accomplished through a mechanism similar to, but separate from, the current Entitlements Program -- a system of payments among refiners designed generally to equalize their crude oil costs.

The mechanism will require importers of crude oil to pay the import fee to the Government. At the same time, however, the importers will be reimbursed for this expense by gasoline producers, who will be required, for each barrel of gasoline produced (whether from domestic or imported crude oil), to purchase an "entitlement" to produce gasoline from any firm which imports crude oil. As a result of the entitlement program, refiners and regions that are dependent upon imported oil will not be disproportionately affected by the new import fee.

TAX ON MOTOR FUELS

Determination of Tax Rate

The President will send to Congress legislation establishing a tax on gasoline and diesel motor fuel, starting at 14 cents per gallon. (The present 4 cents a gallon tax would be repealed.) The rate of tax will be adjusted, not more than quarterly, in accordance with changes in the price indices of producers (refiners) prepared by the Department of Labor.

In that way, the tax will be the equivalent of an ad valorem tax at a constant fixed percentage of producers' average selling prices. The indices will be those for refiners' sales of gasoline and diesel motor fuel to commercial consumers. The gasoline index used will be that for unleaded fuel. Changes in the tax rate will be announced by the Treasury Department. No changes will be made unless the change in an index will result in a tax change of at least one half cent a gallon.

Payment of Taxes

The new taxes will be paid by those who now must pay the 4 cents per gallon tax on gasoline and diesel fuel.

Exemptions, Credits, and Refunds

Many of the existing exemptions, such as for sales to State and local governments, will be retained. In other cases, the magnitude of the exemption, credit, or refund will not be less than under present law.

Floor Stocks Taxes and Refunds

Tax increases or decreases will not be collected or paid on tax-paid products in inventory at the time of change.

Highway Trust Funds

Revenues from the new taxes will be transferred to the Highway Trust Fund in amounts not less than the equivalent of the revenues from a tax of 4 cents a gallon on gasoline and diesel fuel.

Revenue

Each 1 cent of the equivalent tax will raise $1.2 billion annually at 1981 income levels.

Effective Date

The new ad valorem equivalent tax on Motor Fuels is to be effective with the ending of the import fee. Gasoline importers and producers will receive a credit against the new gasoline tax for the import fee or entitlement obligation already paid on gasoline in stock. For diesel fuel, the tax is to be effective the day after the import fee is terminated.

STATE GASOLINE TARGETS

The National Target

The annual national gasoline conservation target will be set at 7.0 million barrels per day, measured according to the Federal Highway Administration (FHWA) data series. These data measure gasoline sales in individual states throughout the nation.

This target is about 5½ per cent below average daily consumption for 1979. Individual states' targets, based on the national target, are being set for the second quarter of 1980. Next week, letters will be sent to the states specifying second quarter targets.

Consultations with the States on Methodology

During the last few weeks, the Department of Energy (DOE) has reviewed a revised methodology for setting individual states' voluntary gasoline conservation targets with officials from the states, Puerto Rico, and the District of Columbia. The comments received indicate the methodology to be basically sound, although DOE will continue to evaluate the revised formula.

The new methodology uses a sum of 12 months of state gasoline sales data -- rather than monthly gasoline tax data used in developing state targets for the first quarter of 1980. Monthly shares are then computed based on prior consumption and prior conservation efforts, and take into account recommendations submitted by state officials for allocating the annual allotment as monthly shares.

The new method of calculating targets is more realistic because monthly data were found to have several reporting variations. It also gives additional weight to the recent lower gasoline consumption which has occurred because of conservation and economic factors.

Monthly Energy Review (EIA) Data Compared to FHWA Data

Two different data series have been used to measure gasoline consumption. The two series are DOE's Monthly Energy Review (MER) and the Federal Highway Administration (FHWA) data series. The FHWA data, because of the inclusion of gasoline which is not imported or produced at domestic refineries, but comes rather from secondary sources, are about 350,000 barrels per day higher than MER data.

For 1979 DOE's MER data reported national gasoline use ("product supplied") at 7.029 million b/d. The corresponding figure reported by FHWA is 7.4 million b/d. Because only the FHWA data system provides information on a state-by-state basis, the national target of 7.0 million b/d is set in terms of FHWA statistics. This national target would likely correspond to an MER "product supplied" figure for 1980 of 6.65 million b/d.

Average Gasoline Consumption in the Last Five Years

	FHWA Data (Approximate)	Monthly Energy Review Data
	(million b/d)	(million b/d)
1975	6.81	6.68
1976	7.13	6.98
1977	7.37	7.18
1978	7.63	7.41
1979	7.40*	7.03

*estimated

Mandatory Targets

It is expected that the target set by the President today will be achieved through voluntary compliance efforts by the States. In his State of the Union address, the President said, "After consultation with the governors, we will set gasoline conservation goals for each of the 50 states, and I will make them mandatory if these goals are not met."

The President has authority to make the targets mandatory pursuant to Section 211 of the Emergency Energy Conservation Act of 1979 (Public Law 96-102, 93 Stat 749(1979)) whenever he finds, with respect to the energy source involved, that "a severe supply interruption exists or is imminent." This criterion is defined in Section 202 of the Act, which in effect empowers the President not only to determine the existence of an interruption, but to act in anticipation of a potential interruption.

If the targets were made mandatory, the States would be required to submit emergency conservation plans within 45 days. If no such plan were submitted, or if disapproved, or if the plan fails substantially to meet the conservation target within a reasonable period of time (but not less than 90 days) and the required statutory shortfall exists or is expected, a standby Federal conservation plan may be ordered implemented in the State.

The standby Federal conservation plan was published in the Federal Register on February 7, 1980, and is currently the subject of public hearings. The comment period ends on April 7, 1980, and a final plan will be issued thereafter.

WITHHOLDING ON INTEREST AND DIVIDENDS

Currently no tax is withheld on payments of interest and dividends to domestic taxpayers, although taxes are withheld from wage recipients. Payors of certain categories of interest and dividends are required to report to the IRS and the recipients the amount of interest and dividends paid.

The President will propose legislation to change the current payment practice. Under the legislation, payors who now report taxable interest and dividends to both IRS and recipients would be required to withhold 15 per cent of such payments. Individuals who reasonably believe they will owe no tax, and exempt organizations, would not be subject to withholding if they file exemption certificates with the interest or dividend payor. This system of reporting and withholding would be extended to interest on other taxable instruments where practical.

A recent IRS report estimated that between $5.4 and $9.4 billion of additional interest income and between $2.1 and $4.7 billion of additional dividend income should have been reported on individual income tax returns in 1976. While only 2-3 per cent of wages and salaries went unreported, the comparable figure for interest and dividends was 9-16 per cent. The use of information documents and audit procedures cannot by themselves effectively close this reporting gap because of the difficulty of following up on millions of interest and dividend transactions.

Withholding at a 15 per cent rate will not result in undue hardship because the lowest rate bracket at present is 14 per cent. Thus, few individuals would be deprived of the use of over-withheld funds until they receive a refund of tax. In addition, under the proposal, persons who reasonably believe they will owe no tax may file exemption certificates and avoid withholding altogether.

Withholding would increase tax collections by $2.5 billion or more per year beginning in fiscal 1981. Practically all this revenue comes from increased compliance, except in the first year, in which much of this increased revenue would come from the acceleration of payments.

	Change in Revenue ($ billion)		
Fiscal year	Increased compliance	Change in Timing	Total
1981	1.0	2.4	3.4
1982	2.2	0.3	2.5
1983	2.5	0.3	2.8

FEDERAL RESERVE press release

For immediate release MARCH 14, 1980

The Federal Reserve Board today announced a series of monetary and credit actions as part of a general government program to help curb inflationary pressures. The actions are:

1. A voluntary Special Credit Restraint Program that will apply to all domestic commercial banks, bank holding companies, business credit extended by finance companies, and credit extended to U.S. residents by the U.S. agencies and branches of foreign banks. The parents and affiliates of those foreign banks are urged to cooperate in similarly restricting their lending to U.S. companies. Special effort will be made to maintain credit for farmers and small businessmen.

2. A program of restraint on certain types of consumer credit, including credit cards, check credit overdraft plans, unsecured personal loans and secured credit where the proceeds are not used to finance the collateral. The Board has established a special deposit requirement of 15 percent for all lenders on increases in covered types of credit. Automobile credit, credit specifically used to finance the purchase of household goods such as furniture and appliances, home improvement loans and mortgage credit are not covered by the program.

3. An increase from 8 percent to 10 percent in the marginal reserve requirement on the managed liabilities of large banks that was first imposed last October 6, and a reduction in the base upon which the reserve requirement is calculated.

4. Restraint on the amount of credit raised by large non-member banks by establishing a special deposit requirement of 10 percent on increases in their managed liabilities.

5. Restraint on the rapid expansion of money market mutual funds by establishing a special deposit requirement of 15 percent on increases in their total assets above the level of March 14.

6. A surcharge on discount borrowings by large banks to discourage frequent use of the discount window and to speed bank adjustments in response to restraint on bank reserves. A surcharge of 3 percentage points applies to borrowings by banks with deposits of $500 million or more for more than one week in a row or more than four weeks in any calendar quarter. The basic discount rate remains at 13 percent.

In making the announcement, the Board said:

"President Carter has announced a broad program of fiscal, energy, credit and other measures designed to moderate and reduce inflationary forces in a manner that can also lay the ground work for a return to stable economic growth.

"Consistent with that objective and with the continuing intent of the Federal Reserve to restrain growth in money and credit during 1980, the Federal Reserve has at the same time taken certain further actions to reinforce the effectiveness of the measures announced in October of 1979. These actions include an increase in the marginal reserve requirements on managed liabilities established on October 6 and a surcharge for large banks on borrowings through the Federal Reserve discount window.

"The President has also provided the Federal Reserve, under the terms of the Credit Control Act of 1969, with authority to exercise particular restraint on the growth of certain types of consumer credit extended by banks and others. That restraint will be achieved through the imposition of a requirement for special deposits equivalent to 15 percent of any expansion of credit provided by credit cards, other forms of unsecured revolving credit, and personal loans.

"One consequence of strong demands for money and credit generated in part by inflationary forces and expectations has been to bring heavy pressure on credit and financial markets generally, with varying impacts on particular sectors of the economy. At the same time, restraint on growth in money and credit must be a fundamental part of the process of restoring stability. That restraint is, and will continue to be, based primarily on control of bank reserves and other traditional instruments of monetary policy. However, the Federal Reserve Board also believes the effectiveness and speed with which appropriate restraint can be achieved without disruptive effects on credit markets will be facilitated by a more formal program of voluntary restraint by important financial intermediaries, developing further the general criteria set forth in earlier communications to member banks."

Special Credit Restraint Program

In adopting this program, the Board said increases in lending this year should generally be consistent with the announced growth ranges for money and credit

reported to Congress on February 19. Although growth trends will vary among banks and regions of the country, growth in bank loans should not generally exceed the upper part of the range of 6-9 percent indicated for bank credit (that is, loans and investments). Banks whose past lending patterns suggest relatively slow growth should expect to confine their growth to the lower portion or even below the range for bank credit.

The Board said the commercial paper market and finance companies--both a growing source of business credit--will be monitored closely in the program. Since activity in the commercial paper market is normally covered by bank credit lines, banks are expected to avoid increases in commitments for credit lines to support such borrowing out of keeping with normal business needs. Thrift institutions and credit unions will not be covered by the special program in light of the reduced trend in their asset growth.

No numerical guidelines for particular types of credit are planned but banks are encouraged particularly:

- To restrain unsecured lending to consumers, including credit cards and other revolving credits. Credit for automobiles, home mortgage and home improvement loans should be treated normally in the light of general market conditions.
- To discourage financing of corporate takeovers or mergers and the retirement of corporate stock, except in those limited instances in which there is a clear justification in terms of production or economic efficiency commensurate with the size of the loan.
- To avoid financing for purely speculative holdings of commodities or precious metals or extraordinary inventory accumulation.
- To maintain availability of funds to small business, farmers homebuyers and others without access to other forms of financing.
- To restrain the growth in commitments for back-up lines in support of commercial paper.

No specific guidelines will be issued on the terms and pricing of bank loans. However, rates should not be calculated in a manner that reflects the cost of relatively small amounts of marginal funds subject to the marginal reserve requirement on managed liabilities. The Board also expects that banks, as appropriate and possible, will adjust lending rates and other terms to take account of the special needs of small business and others.

Lenders covered by the program are asked to supply certain data and information. The President, in activating the Credit Control Act, has provided the authority to require such reports.

Monthly reports are requested from domestic banks with assets in excess of $1 billion and for branches and agencies of foreign banks that have worldwide assets in excess of $1 billion. Monthly reports are also requested on the business credit activities of domestic affiliates of bank holding companies with total assets in excess of $5 billion. Banks with assets between $300 million and $1 billion are asked to report quarterly. Smaller institutions need not report unless subsequent developments warrant it.

Foreign banks will be asked to respect the substance and spirit of the guidelines in their loans to U.S. borrowers or loans designed to support U.S. activity.

A panel of large corporations will be asked to report monthly on their commercial paper issues and their borrowings abroad. Finance companies with more than $1 billion in business loans outstanding will also be asked to report monthly on their business credit outstanding.

Consumer Credit Restraint

The special deposit requirements of 15 percent on increases in some types of consumer credit is designed to encourage particular restraint on such credit extensions. Methods used by lenders to achieve such restraint are a matter for determination by the individual firms. Increases in covered credit above the base date--March 14--will be subject to the special deposit requirement.

Among lenders subject to the regulation are commercial banks, finance companies, credit unions, savings and loan associations, mutual savings banks, retail establishments, gasoline companies and travel and entertainment card companies--in all instances where there is $2 million or more in covered credit.

Typical examples of credit that is covered are credit cards issued by financial institutions, retailers and oil companies; overdraft and special check-type credit plans; unsecured personal loans; loans for which the collateral is already owned by the borrower; open account and 30-day credit without regard to whether a finance charge is imposed; credit secured by financial assets when the collateral is not purchased with the proceeds of the loan.

Examples of consumer credit not covered are:

Secured credit where the security is purchased with the proceeds of the loan such as an automobile, mobile home, furniture or appliance; mortgage loans where the proceeds are used to purchase the home or for home improvements; insurance company policy loans, credit extended for utilities, health or educational services; credit extended under State or Federal government guaranteed loan programs; and savings passbook loans.

All creditors with $2 million or more of covered credit outstanding on March 14 must file a base report by April 1 directly with the Federal Reserve or through the Federal Home Loan Bank Board or the Federal Credit Union Administration. This report will state the amount of credit outstanding on March 14 or a figure for the nearest available date.

Thereafter, these creditors must file a monthly report on the amount of covered consumer credit outstanding during the month, based on the daily average amount of covered credit if that data is available, or the amount outstanding on other appropriate dates approved by the Federal Reserve. The first report--for the period from March 15 through April 30--is due by May 12. The report for subsequent months is due by the second Monday of the following month.

The first 15 percent deposit requirement must be maintained beginning May 22 on increases in outstanding credit.

Marginal Reserve Requirement

On October 6, the Board established an 8 percent marginal reserve requirement on increases in managed liabilities that had been actively used to finance a rapid expansion in bank credit. The base for this reserve requirement was set at the larger of $100 million or the average amount of managed liabilities held by a member bank, an Edge corporation, or a family of U.S. agencies and branches of a foreign bank as of September 13-26. Any increase in managed liabilities above that base period was subject to the additional 8 percent reserve requirement.

Managed liabilities include large time deposits ($100,000 or more) with maturities of less than a year, Eurodollar borrowings, repurchase agreements against U.S. government and federal agency securities, and federal funds borrowed from a nonmember institution.

In today's action, the Board increased the reserve requirement to 10 percent and lowered the base by (a) 7 percent or (b) the decrease in a bank's gross loans to foreigners and gross balances due from foreign offices of other institutions between the base period and the week ending March 12, whichever is greater. In addition, the base will be reduced to the extent a bank's foreign loans continue to decline. The minimum base amount remains at $100 million.

Nonmember Banks

The special deposit requirement for nonmember banks is designed to restrain credit expansion in the same manner as the marginal reserve requirement on the managed liabilities of member banks.

For nonmembers, the base is the two-week period that ended March 12 or $100 million, whichever is greater. The 10 percent special deposit will be maintained

at the Federal Reserve on increases in managed liabilities above the base amount. The base will be reduced in subsequent periods to the extent that a nonmember bank reduces its foreign loans.

Money Market Mutual Funds

Money market mutual funds and similar creditors must maintain a special deposit with the Federal Reserve equal to 15 percent of the increase in their total assets after March 14.

A covered fund must file by April 1 a base report of its outstanding assets as of March 14. Thereafter, a monthly report on the daily average amount of its assets must be filed by the 21st of the month. For example, a report on the first month's assets--from March 15 to April 14--must be filed by April 21 and the special deposit requirement will be maintained beginning May 1. A fund that registers as an investment company with the Securities and Exchange Commission after March 14 must file a base report within two weeks after it begins operations.

Discount Rate

In fixing the surcharge for large bank borrowing, the Board acted on requests from the directors of all 12 Federal Reserve Banks. The action is effective Monday. The discount rate is the interest rate that member banks are charged when they borrow from their district Federal Reserve Bank.

The surcharge above the basic discount rate would generally be related to market interest rates. It is designed to discourage frequent use of the discount window and to encourage banks with access to money markets to adjust their loans and investments more promptly to changing market conditions. This should facilitate the ability of the Federal Reserve to attain longer-run bank credit and money supply objectives.

The surcharge will apply to banks with more than $500 million in deposits on their borrowings for ordinary adjustment credit, when such borrowing occurs successively in two statement weeks or more, or when the borrowing occurs in more

than four weeks in a calendar quarter. There will be no other change in the administration of the discount window with respect to adjustment credit. Such credit will continue to be available to member banks only on a short-term basis to assist them in meeting a temporary requirement for funds or to provide a cushion while orderly adjustments are made in response to more subtained charges in a bank's position.

The surcharge will not apply to borrowing under the seasonal loan program, which will continue at the basic discount rate, nor to borrowing under the emergency loan program.

Attached are copies of the following documents:

1. The Special Credit Restraint Program.
2. A regulation establishing a special deposit requirement on increases in certain types of consumer credit.
3. An amendment to Regulation D increasing the marginal reserve requirement on managed liabilities to 10 percent and reducing the base period.
4. A regulation subpart establishing a special deposit requirement for nonmember banks.
5. A regulation subpart establishing a special deposit requirement for money market mutual funds.

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Special Credit Restraint Program

Background

President Carter has announced a broad program of fiscal, energy, credit, and other measures designed to moderate and reduce inflationary forces in a manner that can also lay the groundwork for a return to stable economic growth.

In connection with those actions, and consistent with the continuing objective to restrain growth in money and credit during 1980, the Federal Reserve has also taken certain further actions to reinforce the effectiveness of the measures announced in October of 1979. These actions include an increase in the marginal reserve requirements on managed liabilities established on October 6 and the establishment of a surcharge on borrowings through the discount window by large banks.

The President has also authorized the Federal Reserve, under the terms of the Credit Control Act of 1969, to exercise particular restraint on certain types of credit. The Board has determined to restrain the growth of certain types of consumer credit through the imposition of a requirement for special deposits equivalent to 15% of any expansion of consumer credit provided by any lender through credit cards, other forms of unsecured revolving credit, and personal loans. Under the authority of the Credit Control Act, the Federal Reserve has also (a) applied a special deposit requirement on the growth of managed liabilities of large non-member banks and (b) imposed a special deposit requirement on the growth in the net assets of money market mutual funds and other similar entities.

One consequence of strong demands for money and credit generated in part by inflationary forces and expectations has been to bring heavy pressure on credit and financial markets generally, with varying impacts on particular sectors of the economy. At the same time, restraint on growth in money and credit must be a fundamental part of the process of restoring stability. That restraint is, and will continue to be, based primarily on control of bank reserves and other traditional instruments of monetary policy. However, the Federal Reserve Board also believes

the effectiveness and speed with which appropriate restraint can be achieved without unnecessarily disruptive effects on credit markets will be facilitated by a program of voluntary credit restraint by important financial intermediaries. The program set forth here develops certain general criteria to help guide banks and others in their lending policies during the period ahead.

Statement of Purpose

The purpose of the Special Credit Restraint Program is to encourage lenders and borrowers, in their individual credit decisions, to take specific account of the overall aims and quantitative objectives of the Federal Reserve in restraining growth in money and credit generally. The guidelines set forth are consistent with the continuing interest of the Federal Reserve and individual institutions to:

- Meet the basic needs of established customers for normal operations, particularly smaller businesses, farmers, thrift institution bank customers, and agriculturally-oriented correspondent banks, and homebuyers with limited alternative sources of funds.
- Avoid use of available credit resources to support essentially speculative uses of funds, including voluntary buildup of inventories by businesses beyond operating needs, or to finance transactions such as takeovers or mergers that can resasonably be postponed, that do not contribute to economic efficiency or productivity, or may be financed from other sources of funds.
- Limit overall loan growth so that adequate provision is made for liquidity and acceptable capital ratios.

In requesting cooperation of individual institutional lenders in achieving the general objectives of this program, the Federal Reserve Board is strongly conscious of the fact that sound decisions concerning the distribution of credit and specific loans

can be made only by individual institutions dealing directly in financial markets and intimately familiar with the needs and conditions of particular customers. We are also aware, however, that in existing market circumstances, individual institutions may be under competitive pressure to make loans or commitments that, in the aggregate, cannot be sustained within our overall monetary and credit objectives or that, for particular institutions, may exceed prudent limits. By more clearly considering individual lending and commitment decisions in the light of the national objectives reflected in this program, undue market pressures and disturbances can be avoided and available credit supplies be used to meet more urgent requirements.

Nature of the Program

Coverage

The Special Credit Restraint Program will be directed primarily toward the domestic credit supplied by commercial banks and the domestic business credit extended by finance companies. Surveillance will also be exercised over borrowing in the commercial paper market and borrowings abroad by U.S. corporations.

With regard to domestic commercial banks, the program is designed to cover credit extended to U.S. residents by both the domestic and overseas offices of such banks. Credit extended to U.S. residents by agencies and branches of foreign banks domiciled in the United States will be specifically covered. Affiliates abroad of banks operating in the U.S. are expected to respect the substance and spirit of the guidelines in their loans to U.S. borrowers or loans otherwise designed to support U.S. activity.

In recent months, the commercial paper market and finance companies have been a growing source of business credit. In recognition of this trend and to assure comparable competitive treatment, finance companies (including subsidiaries of bank holding companies) are asked to follow the general guidelines in their business lending.

Activity in the commercial paper market is normally covered by bank credit lines. That practice is strongly encouraged in the interest of continuing to provide a sound base to that market. But the use of commercial paper should be restrained, and growth in the market and activity of the larger users of that market will be closely monitored. For their part, banks are expected to give special attention to avoiding increases in commitments for credit lines for purposes of supporting commercial paper borrowing for other than normal business operating purposes.

Thrift institutions and credit unions are not specifically covered by the Special Program in light of recent patterns in their asset growth.

Reporting arrangements are described below.

Quantitative Guidelines

The Federal Reserve has recently set forth growth ranges for the monetary aggregates for 1980 as follows:

M1A	3½%	-	6%
M1B	4%	-	6½%
M2	6%	-	9%
M3	6½%	-	9½%

The growth ranges set forth for M3 encompass almost all the relatively short-term liabilities of banks and other depository institutions. That liability growth was broadly estimated to be consistent with growth in total bank credit (loans and investments) of 6-9%. We are aware that in current market circumstances, banks may be requested to carry a larger than normal share of growth in business and certain other types of credit. However, prudent attention to liquidity and capital positions will also be required, and liquidity of banks is already somewhat depleted. Taking these factors into account, growth in bank loans, consistent with the monetary growth ranges and maintenance of prudent liquidity positions, should not generally exceed the upper part of the indicated range of growth in total bank credit. That growth should

be spread out over time in an orderly fashion, taking account of normal seasonal patterns.

Growth trends vary among banks and regions of the country. Individual institutions will wish to appraise their own prospects and policies in that light. Banks whose past patterns suggest relatively slow growth, and particularly those serving more slowly growing areas, should expect to confine growth to the lower portion or even below the indicated range for bank credit, particularly in instances where liquidity or capital ratios are below average. More rapidly growing banks should also evaluate their ability to support such growth without impairing liquidity or capital ratios.

The Federal Reserve and other federal bank regulatory agencies will carefully review patterns of loans and commitments at institutions that are experiencing growth in lending at or above the top of the range specified. Account will be taken of their own past experience and regional trends as well as the banks' capacity to finance their loan portfolios without straining capital or liquidity. Increases in loans by banks resulting in lower capital or liquidity ratios, particularly when the bank ratios are below peer groups, will be especially closely reviewed to assure their position is not weakened. In that connection, other regulatory authorities will be consulted as appropriate.

Individual institutions should adopt commitment policies that enable them to maintain adequate control over growth in loan totals and to assure funds are available to meet the priority needs specified below.

Qualitative Guidelines

The Board does not intend to set forth numerical guidelines for particular types of credit. However, banks are encouraged particularly:

(1) To restrain unsecured lending to consumers, including credit cards and other revolving credits. Credit for auto,

home mortgage and home improvement loans should not be subject to extraordinary restraint.

(2) To discourage financing of corporate takeovers or mergers and the retirement of corporate stock, except in those limited instances in which there is a clear justification in terms of production or economic efficiency commensurate with the size of the loan.

(3) To avoid financing of purely speculative holdings of commodities or precious metals or extraordinary inventory accumulation out of keeping with business operating needs.

(4) To maintain reasonable availability of funds to small businesses, farmers, and others without access to other forms of financing.

(5) To restrain the growth in commitments for backup lines in support of commercial paper.

(6) To maintain adequate flow of credit to smaller correspondent banks serving agricultural areas and small business needs and thrift institutions.

The terms and pricing of bank loans are expected to reflect the general circumstances of the marketplace. No specific guidelines or formulas are suggested. However, the Board does not feel it appropriate that lending rates be calculated in a manner that reflects the cost of relatively small amounts of marginal funds subject to the marginal reserve requirements on managed liabilities. Moreover, the Board expects that banks, as appropriate and possible, will adjust lending rates and other terms to take account of the special needs of small businesses, including farmers, and others.

Reporting

The Federal Reserve will closely monitor developments in all sectors of the credit markets and will ask that certain data and information be supplied by banks and others. The President, in activating the Credit Control Act of 1969, has provided authority for requiring such reports.

In the case of domestic banks with assets in excess of $1 billion, and for U.S. branches and agencies of foreign banks that have worldwide assets in excess of $1 billion, a monthly report will be requested. Monthly reports will also be requested on the business credit activities of domestic affiliates of bank holding companies with U.S. financial assets in excess of $1 billion. As will be noted, the bank reports include, apart from qualitative information, certain data on the movements in broad categories of loans and commitments, liquid asset holdings, and capital accounts. Certain data, including that on capital and liquidity, will be requested on a consolidated worldwide basis. Banks with less than $1 billion but more than $300 million in assets will report quarterly. Smaller institutions, while requested to observe the program, will not have special reporting requirements unless warranted by subsequent developments.

A group of large corporations will be requested to complete a brief monthly form about their activities in the commercial paper market, including the extent and usage of "backup" lines of credit at banks and their borrowing abroad. Finally, finance companies -- including subsidiaries of bank holding companies -- with more than $1 billion in loans outstanding to business borrowers will be requested to provide monthly reports concerning their business lending activities.

Consultative Arrangements

In instances warranted by trends in loans and commitments, Federal Reserve Bank officials in consultation with other federal bank regulatory agencies, will review with individual banks and others their progress in achieving and

maintaining appropriate restraint on lending. In general, such consultations will be sought if:

(1) Bank or finance company lending is occurring at a pace that appears to be significantly in excess of the national objective, taking account of the location or past experience of the bank or other institution.

(2) Commitment policies appear to suggest the possibility of large subsequent increases in lending or exceptional expansion of commercial paper borrowing.

(3) Explanations of "takeover" or "speculative" financing contained in regular reports raise significant questions.

(4) The distribution of credit at an institution generally appears disproportionate in light of the qualitative guidelines above.

(5) Liquidity positions or capital ratios reflect developing strains, particularly in the case of institutions whose ratios are below peer group averages.

In the case of nonbanks, the Federal Reserve may also wish to hold informal discussions with such institutions if such discussions seem warranted by developments.

TITLE 12--BANKS AND BANKING

CHAPTER II--FEDERAL RESERVE SYSTEM

SUBCHAPTER A -- BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

(Docket No. R-0280)

Part 229--CREDIT RESTRAINT

[Subpart A]

Consumer Credit

AGENCY: Board of Governors of the Federal Reserve System.

ACTION: Final Rule.

SUMMARY: Pursuant to the Credit Control Act (12 U.S.C. §§ 1901-1909) as implemented by Executive Order 12201, the Board has adopted provisions requiring creditors that extend certain types of consumer credit to maintain a special non-interest bearing deposit with the Federal Reserve equal to 15% of the amount by which certain types of the creditor's outstanding consumer credit exceeds the larger of $2 million or the amount of such credit outstanding on March 14, 1980 (or the last day or other period immediately prior to March 14, 1980 for which data are available). Members of the Federal Home Loan Banks and all other savings and loan associations shall maintain the special deposit with the Federal Home Loan Banks. Credit unions, whether or not members of the National Credit Union Administration's Central Liquidity Facility, shall maintain the special deposit with the Central Liquidity Facility. The types of consumer credit covered by this regulation include credit extended through the use of credit cards, unsecured consumer loans, and secured consumer credit where the proceeds are not being used to purchase the collateral. Credit extended for business and agricultural purposes and closed-end consumer credit secured by the collateral financed are not subject to the regulation. The purpose of this action is to help curb inflationary pressures in the economy.

EFFECTIVE DATE: March 14, 1980.

FOR FURTHER INFORMATION CONTACT: Robert E. Mannion, Deputy General Counsel; Gilbert T. Schwartz, Assistant General Counsel; or Margaret L. Egginton, Attorney; Legal Division, Board of Governors of the Federal Reserve System, Washington, D.C. 20551 (202/452-3000).

SUPPLEMENTARY INFORMATION: In accordance with the Credit Control Act (12 U.S.C. §§ 1901-1909) as implemented by Executive Order 12201, dated March 14, 1980, the Board has adopted this regulation to require certain creditors that extend certain types of consumer credit to hold a special deposit with the Federal Reserve Banks against increases in

the amount of those types of credit outstanding. Creditors that have less than $2 million of consumer credit outstanding of the types covered by the regulation will not be required to maintain the special deposit. The amount of the special deposit that must be held will be equal to 15% of the amount by which certain types of consumer credit extended by the creditor exceeds the larger of $2 million or the amount of such credit outstanding as of the base date. For creditors that have daily credit data available, the base date is March 14, 1980 or the last day before March 14, 1980 for which such data are available. For creditors that do not have daily credit data available, the base date is the period immediately prior to March 14, 1980 for which credit data are available.

The regulation will apply to (1) all open-end consumer credit, whether secured or unsecured and (2) closed-end consumer credit that is either unsecured or secured by collateral that is not being purchased with the proceeds of the credit. Examples of open-end consumer credit are:

- credit card plans, such as cards issued by financial institutions, retailers, and oil companies;

- overdraft and special check-type credit plans offered by financial institutions;

- other revolving credit plans.

Examples of closed-end consumer credit that is covered are:

- unsecured personal loans;

- loans for which the collateral provided is already owned by the borrower;

- open account and 30-day credit without regard to whether a finance charge is imposed, such as travel and entertainment card plans and retail merchant credit;

- credit secured by financial assets, other than savings deposits, when the collateral is not purchased with the loan proceeds.

Credit extended through the use of credit cards will be presumed to be consumer -- that is, non-business -- credit unless the creditor establishes otherwise. A creditor also will be required to treat as covered consumer credit any such credit that is sold or otherwise transferred to any non-U. S. office of the same or another entity and any such credit sold or otherwise transferred with recourse to another entity wherever located.

Examples of consumer credit that is not covered are:

- secured credit where the collateral is purchased with the proceeds of the loan, such as automobile, mobile home, and other chattel secured loans (see Uniform Commercial Code § 9-107, including Official Comments 1 and 2);

- credit secured by financial assets when the collateral is purchased with the proceeds;

- credit secured by savings deposits held at the lending institution;

- mortgage loans where the proceeds are used to purchase the collateral or for home improvements or "bridge" loans;

- insurance company policy loans;

- credit extended by providers of utility, health and educational services;

- credit extended under state or federal government guaranteed consumer loan programs, such as student loans.

All creditors with $2 million or more of covered consumer credit outstanding as of the base date are required to file a base report on the amount of such credit outstanding with the Federal Reserve Banks by April 1, 1980. If daily data are available, a creditor shall report as its base the actual amount of covered credit outstanding on March 14, 1980 or the last day before March 14 for which such data are available; if daily data are not available, the creditor shall report as its base the amount of such credit outstanding during the last period immediately before March 14, 1980, for which such data are available. A base report may be also required of certain creditors with covered consumer credit of less than $2 million. All creditors with $2 million or more of covered consumer credit outstanding as of the base date or anytime thereafter on an average basis during any calendar month shall file monthly reports on the amount of covered consumer credit outstanding. The monthly report on the average amount of covered consumer credit outstanding during the calendar month shall be filed by the second Monday of the following month. For example, a report on the daily average amount of covered credit outstanding during May shall be filed by June 9, 1980. The initial monthly report, however, shall cover the period from March 15, 1980 through April 30, 1980 and shall be filed by May 13, 1980.

Based upon the monthly report, a covered creditor is required to maintain a special non-interest bearing deposit with the Federal Reserve (or with the Federal Home Loan Bank or Central Liquidity Facility) equal to 15% of the amount by which the average amount of its covered credit exceeds the reported base or $2 million, whichever is greater. The special deposit shall be maintained in collected funds,

in the form of U. S. dollars, during the period beginning on the fourth Thursday of the month following the month for which the last report has been filed and ending on the day prior to the fourth Thursday of the next month. For example, the report covering the month of May shall be filed by June 9, 1980, and the special deposit based upon the May report shall be held beginning June 26, 1980, and continue through July 23, 1980, at which time a special deposit based upon June's report shall be required. The deposit based on the initial report, for March 15 through April 30, 1980, shall be maintained beginning May 22, 1980 and ending June 25, 1980. The amount of the special deposit may not vary during each maintenance period. Federal Reserve services, such as check collection, will not be made available based on maintenance of the special deposit.

Members of the Federal Home Loan Banks and all other savings and loan associations shall file reports and maintain the special deposit with the Federal Home Loan Banks. Credit unions, whether or not members of the National Credit Union Administration's Central Liquidity Facility, shall file reports and maintain the special deposit with the Central Liquidity Facility. Deposits maintained with the Federal Home Loan Banks and the Central Liquidity Facility shall be passed through by those entities to the Federal Reserve Banks. All other covered creditors, including commercial banks, U.S. branches and agencies of foreign banks, retailers, other credit card issuers, and finance companies, are required to file reports and maintain the special deposit with the Federal Reserve Bank for the District in which the reporting office of the creditor is located.

For purposes of reporting and determining whether the creditor's outstanding covered credit exceeds the $2 million threshold during the base period or thereafter, the covered credit of all U. S. offices of the same company and direct and indirect U. S. subsidiaries of the same parent company shall be combined, and only one base and monthly report shall be filed for the combined organization. For example, if a company has 100 offices throughout the United States, it should combine the required information from each office, and one designated reporting office should file one combined base or monthly report for the entire company. The covered credit of all U. S. offices (such as the branches, agencies and subsidiaries, including banks) of the same foreign parent company and all U.S. offices of that foreign parent's non-U.S. subsidiaries shall be combined and one office selected as the reporting office for such offices. A subsidiary is a company that is more than 50 per cent owned, directly or indirectly, by another.

These actions are being taken to curb inflationary pressures. Continuing growth of consumer credit has contributed to inflationary forces by helping to sustain consumer demand for goods and services. As a consequence of this sustained high level of demand, savings in the economy have fallen to the lowest level since the Korean War. Restraint on consumer credit will tend to encourage additional savings, which can be channelled to productive investment to increase the supply of goods. At the same time, consumer demands for the supply of goods available will be restrained. In both of these ways, restraint on consumer credit will contribute to dampening inflationary forces. The particular types of credit to which these restraints will apply are those generally showing undue strength in recent months. Thus, automobile credit, residential mortgage credit, and credit extended to purchase the collateral will not be affected by this action.

The Board believes that it is in the national interest to achieve the objective of curbing inflation as quickly as possible, and that publication of this rule for comment or any delay in its effective date would lead to rapid increases in extensions of consumer credit that would not be subject to the regulation and would frustrate its purpose. The Board, therefore, for good cause finds that further notice, public procedure, and deferral of effective date provisions of 5 U.S.C. § 553(b) with regard to these actions are impracticable and contrary to the public interest.

Pursuant to its authority under the Credit Control Act (12 U.S.C. §§ 1901-1909) as implemented by Executive Order 12201, the Board hereby issues this subpart (12 C.F.R. 229, Subpart A) effective March 14, 1980, as follows:

SECTION 229.1 - AUTHORITY, PURPOSE, AND SCOPE

(a) Authority. This subpart is issued by the Board of Governors of the Federal Reserve System pursuant to the Credit Control Act (12 U.S.C. §§ 1901-1909) as implemented by Executive Order 12201, dated March 14, 1980.

(b) Purpose and Scope. This subpart is intended to curb inflation generated by the extension of certain types of consumer credit in an excessive volume and governs extensions of such credit by all covered creditors.

SECTION 229.2 - DEFINITIONS

(a) For the purposes of this subpart, the terms, "Board," "credit," "creditor," "extension of credit" and "credit transaction," and "loan," shall have the meanings given them in the Credit Control Act. In addition, the following definitions apply.

(b) "Base" means the larger of $2 million or the amount of covered credit outstanding as of the close of business on the base date.

(c) "Base date" means: for a creditor that has daily credit data available, March 14, 1980 or the last day immediately before March 14, 1980 for which such data are available; for a creditor that does not have daily credit data available, the period immediately before March 14, 1980 for which credit data are available.

(d) "Closed-end credit" means all consumer credit except open-end credit.

(e) "Consumer credit" means credit extended in the U. S. primarily for personal, family, or household purposes and does not include credit for business or agricultural purposes.

(f) "Covered credit" means consumer credit that is (1) open-end credit and (2) closed-end credit which is unsecured or in which the proceeds of the credit are not being used to purchase the collateral. Covered credit that is sold or otherwise transferred after March 14, 1980 to any office located outside the U. S. of the same or another entity shall remain the covered credit of the transferor until such credit is repaid. Covered credit that is sold or otherwise transferred on a recourse basis to any U. S. office of the same or another entity shall remain the covered credit of the transferor; covered credit that is transferred on a non-recourse basis to any U. S. office of the same or another entity shall be treated as covered credit of the transferee. Covered credit does not include insurance company policy loans; credit extended by federal, state or local governments, or by providers of utility, health or education services; state or federal government guaranteed loans; or loans secured by savings deposits[1/] held at the lending institution.

(g) "Covered creditor" means any creditor which extends covered credit. For purposes of determining the amount of a creditor's outstanding covered credit, the covered credit of all U. S. offices of (i) the same company, (ii) U. S. subsidiaries of the same parent company, and (iii) non-U. S. subsidiaries of the same parent company shall be combined. A subsidiary is a company that is more than 50 per cent owned directly or indirectly by another company.

(h) "Open-end credit" means consumer credit extended on an account pursuant to a plan under which (1) the creditor may permit the customer to make purchases or obtain loans, from time to time, directly from the creditor or indirectly by use of a credit card, check, or other

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1/ As defined in § 217.1(e) of this Chapter (Regulation Q).

device, as the plan may provide; (2) the customer has the privilege of paying the balance in full or in instalments; and (3) a finance charge may be computed by the creditor from time to time on an outstanding unpaid balance.

(i) "U.S." means the fifty states of the United States and the District of Columbia.

SECTION 229.3 - REPORTS

(a) Each covered creditor with $2 million or more of covered credit outstanding as of the base date, and certain covered creditors as may be required by the Board, shall file a base report by April 1, 1980. The base report shall state the amount of the covered creditor's base. A creditor with a base of $2 million or more as indicated on its base report, or with covered credit outstanding in excess of $2 million on an average basis during any calendar month, shall submit monthly reports. The initial monthly report shall be filed by May 12, 1980, for the period March 15 through April 30, 1980; thereafter, the monthly report shall be filed for each full calendar month by the second Monday of the following month. The monthly report shall include the average amount of covered credit outstanding during the month (on a daily average basis if such data are available) and the amount by which that number exceeds the creditor's base.

(b) One base and one monthly report shall be filed by a reporting office for all the offices of a covered creditor. A covered creditor may designate any of its offices as its reporting office.

(c) Members of the Federal Home Loan Banks and all other savings and loan associations shall file reports with the Federal Home Loan Banks. Credit unions, whether or not members of the National Credit Union Administration's Central Liquidity Facility, shall file reports with the Central Liquidity Facility. All other creditors shall file reports with the Federal Reserve Bank in whose District their reporting office is located.

SECTION 229.4 - MAINTENANCE OF SPECIAL DEPOSIT

(a) Each covered creditor shall hold a non-interest bearing special deposit equal to 15 per cent of the amount by which the average amount of its covered credit outstanding during the calendar month exceeds its base. The corresponding period during which the special deposit shall be maintained begins on the fourth Thursday of the month following the calendar month for which the report was filed and continues through the Wednesday before the fourth Thursday of the next month. The special deposit shall be maintained in collected funds in the form of U. S. dollars.

(b) Members of the Federal Home Loan Banks and all other savings and loan associations shall maintain the special deposit with the Federal Home Loan Banks. Credit unions, whether or not members of the National Credit Union Administration's Central Liquidity Facility, shall maintain the special deposit with the Central Liquidity Facility. Deposits maintained with the Federal Home Loan Banks and the Central Liquidity Facility shall be placed with a Federal Reserve Bank. All other creditors shall maintain the special deposit with the Federal Reserve Bank to which the creditor reports.

SECTION 229.5 - PENALTIES

For each willful violation of this subpart, the Board may assess against any creditor, or officer, director or employee thereof who willfully participates in the violation, a maximum civil penalty of $1,000. In addition, a maximum criminal penalty of $1,000 and imprisonment of up to one year may be imposed for willful violation of this subpart.

By order of the Board of Governors of the Federal Reserve System, effective March 14, 1980.

(Signed) Theodore E. Allison

Theodore E. Allison
Secretary of the Board

[SEAL]

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TITLE 12—BANKS AND BANKING

CHAPTER II—FEDERAL RESERVE SYSTEM

SUBCHAPTER A—BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

[Regulation D]

(Docket No. R-0278)

Part 204—RESERVES OF MEMBER BANKS

Marginal Reserve Requirements

AGENCY: Board of Governors of the Federal Reserve System.

ACTION: Final rule.

SUMMARY: On October 6, 1979, the Board of Governors amended Regulation D to establish a marginal reserve requirement of 8 per cent on the amount by which the total of certain managed liabilities of member banks (and Edge and Agreement Corporations) and United States branches and agencies of foreign banks exceeds the amount of an institution's base of managed liabilities. An institution's base was defined as the daily average total of managed liabilities outstanding during the period September 13-26, 1979, or $100 million, whichever is greater. The Board has amended Regulation D to increase the marginal reserve requirement ratio to 10 per cent. The Board also has amended Regulation D to reduce an institution's managed liabilities base by the greater of 7 per cent or the amount of decrease in an institution's daily average gross loans to non-United States residents and gross balances due from foreign offices of other institutions between the base period (September 13-26, 1979) and the statement week ending March 12, 1980. In the future, an institution's base will be reduced further after March 12, 1980, by the amount by which it decreases its daily average gross loans to non-U. S. residents and gross balances due from foreign offices of other institutions during a statement week. However, in no event will the base of an institution that was a net borrower of managed liabilities during the base period (September 13-26, 1979) be reduced below $100 million. The purpose of this action is to control further the availability of bank credit.

EFFECTIVE DATE: This action is effective for marginal reserves required to be maintained during the seven-day period beginning April 3, 1980, against total managed liabilities outstanding during the seven-day period beginning on March 20, 1980.

FOR FURTHER INFORMATION CONTACT: Gilbert T. Schwartz, Assistant General Counsel (202/452-3625), Anthony F. Cole, Senior Attorney (202/452-3612), or Paul S. Pilecki, Attorney (202/452-3281), Legal Division, Board of Governors of the Federal Reserve System, Washington, D. C. 20551.

SUPPLEMENTARY INFORMATION: On October 6, 1979, the Board of Governors amended Regulation D (12 CFR Part 204) to impose a marginal reserve requirement of 8 per cent on the amount by which the total managed liabilities of member banks (and Edge and Agreement Corporations) and United States branches and agencies of foreign banks with total worldwide consolidated bank assets in excess of $1 billion exceeds the amount of the institution's managed liabilities outstanding during the base period (September 13-26, 1979) or $100 million, whichever is greater (44 Fed. Reg. 60071). Managed liabilities include the total of (1) time deposits in denominations of $100,000 or more with original maturities of less than one year; (2) Federal funds borrowings with original maturities of less than one year from U. S. offices of depository institutions not required to maintain Federal reserves and from U. S. government agencies; (3) repurchase agreements with original maturities of less than one year on U. S. government and agency securities entered into with parties other than institutions required to maintain Federal reserves; and (4) Eurodollar borrowings from foreign banking offices, asset sales to related foreign offices and member bank foreign office loans to U. S. residents. The purpose of this action was to better control the expansion of bank credit, help curb speculative excesses in financial, foreign exchange and commodity markets and thereby serve to dampen inflationary forces.

Under the marginal reserve program, the amount of marginal reserves that a member bank, Edge or Agreement Corporation, or a U. S. branch or agency family of a foreign bank that is a net borrower of managed liabilities is required to maintain is determined by the amount by which the total of the institution's managed liabilities during a given seven-day reserve computation period exceeds the daily average amount of managed liabilities outstanding during the base period or $100 million, whichever is greater. For an institution that is a net lender of managed liabilities (that is, the sum of its managed liabilities is negative because its net Eurodollar loans to its foreign offices are greater than the total of its other managed liabilities), its managed liabilities base is the algebraic sum of its managed liabilities and $100 million.

The Board has determined to increase the marginal reserve requirement ratio to 10 per cent and also has determined to adjust the base amount of managed liabilities for institutions subject to the marginal reserve requirement program. For reserve computation periods beginning March 20, 1980, if an institution was a net borrower of managed liabilities during the base period, its base amount will be reduced by an amount equal to the greater of 7 per cent of its current base or an amount equal to the decrease in the sum of its daily average gross loans to non-United States residents and gross balances due from foreign offices of other institutions from the base period (September 13-26, 1979) to the seven-day statement week ending March 12, 1980. For example,

if an institution has a borrowed managed liabilities base of $250 million, its base would be reduced by at least $17.5 million (7 per cent x $250 million). However, if such institution's daily average of gross loans to non-United States residents and gross balances due from foreign offices of other institutions decreased between the base period (September 13-26, 1979) and the statement week ended March 12, 1980, by $25 million, then the new managed liabilities base for such institution would be $225 million, since the decrease in daily average of such loans and balances was greater than 7 per cent. Consequently, the marginal reserve ratio of 10 per cent would be applied to the institution's managed liabilities in excess of $225 million.

The managed liabilities base shall be further reduced in reserve computation periods beginning March 20, 1980, by the amount by which the institution's daily average of gross loans to non-United States residents and gross balances due from foreign offices of other institutions during the statement week is lower than the daily average amount of such loans and balances during the statement week ending on March 12, 1980. In order to minimize the reserve impact of small repayments or reductions in the daily average gross loans to non-United States residents and balances due from foreign offices of other institutions, a future reduction in such loans and balances below the daily average for the week ending March 12, 1980, will reduce the base only in increments of $2 million. For example, if an institution reduces such loans and balances by a daily average of $12.5 million during the statement week ending March 26, 1980, its base for that week and future weeks will be reduced by $12 million. This approach also will enable institutions to receive ordinary repayments of foreign loans without being required to relend such funds immediately to avoid increased marginal reserves. The base for an institution that was a net borrower of managed liabilities during the base period (September 13-26, 1979), will not be reduced below $100 million. The base will not change for an institution that was a net lender of managed liabilities during the base period. An institution's base will not be affected by an increase in daily average gross loans to non-United States residents. In addition, eligible bankers' acceptances not held in the issuer's own portfolio will not be regarded as loans for purposes of determining reductions in the managed liabilities base.

These actions are being taken to moderate expansion of bank credit, thereby dampening inflationary pressures. In order to achieve the above stated objectives as soon as possible, the Board for good cause finds that the notice, public procedure, and deferral of effective date provisions of 5 U.S.C. § 553(b) with regard to these actions are impracticable and contrary to the public interest.

These actions are taken pursuant to the Board's authority under sections 19, 25 and 25(a) of the Federal Reserve Act (12 U.S.C. §§ 461, 601 et seq.) and under section 7 of the International Banking Act of 1978 (12 U.S.C. § 3105).

Effective April 3, 1980, section 204.5 of Regulation D (12 CFR § 204.5) is revised as follows:

§ 204.5 RESERVE REQUIREMENTS

* * * * *

(f) Marginal Reserve Requirements.

(1) Member banks. A member bank shall maintain a daily average reserve balance against its time deposits equal to 10 per cent of the amount by which the daily average of its total managed liabilities during the seven-day computation period ending eight days prior to the beginning of the corresponding seven-day reserve maintenance period exceeds the member bank's managed liabilities base as determined in accordance with subparagraph (3). A member bank's managed liabilities are the total of the following; * * *

(2) United States branches and agencies of foreign banks. A United States branch or agency of a foreign bank with total worldwide consolidated bank assets in excess of $1 billion shall maintain a daily average reserve balance against its liabilities equal to 10 per cent of the amount by which the daily average of its total managed liabilities during the seven-day computation period ending eight days prior to the beginning of the corresponding seven-day reserve maintenance period exceeds the institution's managed liabilities base as determined in accordance with subparagraph (3). In determining managed liabilities of United States branches and agencies, the managed liabilities of all United States branches and agencies of the same foreign parent bank and of its majority-owned (greater than 50 per cent) foreign banking subsidiaries (the "family") shall be consolidated. Asset and liability amounts that represent intra-family transactions between United States branches and agencies of the same family shall not be included in computing the managed liabilities of the family. United States branches and agencies of the same family shall designate one U.S. office to be the reporting office for purposes of filing consolidated family reports required for determination of the family's marginal reserve requirements. The reporting office shall file reports and maintain marginal reserves required under this section for the family at the Federal Reserve Bank of the district in which the reporting office is located. The total managed liabilities of a family are the total of each branch's and agency's; * * *

(3) Managed liabilities base. During the seven-day reserve computation period beginning March 20, 1980, and during each seven-day reserve computation period thereafter, the managed liabilities base of a member bank or a family of United States branches and agencies of a foreign bank ("family") shall be determined as follows:

(i) For a member bank or family that, on a daily average basis, is a net borrower of total managed liabilities during the fourteen-day base period ending September 26, 1979, its managed liabilities base shall be the daily average of its total managed liabilities during the base period less the greater of

(A) 7 per cent of the daily average of its total managed liabilities during the base period; or

(B) the amount equal to the decrease in its daily average gross loans to non-United States residents[18] and gross balances due from foreign offices of other institutions[19] or to institutions, the time deposits of which are exempt from the rate limitations of Regulation Q pursuant to § 217.3(g) thereof[20] between the fourteen-day base period ending September 26, 1979, and the computation period ending March 12, 1980.

For each computation period beginning after March 19, 1980, the managed liabilities base of a member bank or family shall be further reduced during the computation period by the amount by which its lowest daily average of gross loans to non-United States residents[18] and gross balances due from foreign offices of other institutions[19] or to institutions the time deposits of which are exempt from the rate limitations of Regulation Q pursuant to § 217.3(g) thereof[20] outstanding during any computation period beginning after March 19, 1980, is lower than the daily average amount of such loans and balances outstanding during the computation period ending on March 12, 1980. The amount representing such difference shall be rounded to the next lowest $2 million.

In no event will the managed liabilities base for an institution that was a net borrower of managed liabilities during the fourteen-day base period ending September 26, 1979 be less than $100 million.

(ii) For a member bank or family that, on a daily average basis, is a net lender of total managed liabilities during the fourteen-day base period ending September 26, 1979, its managed liabilities base shall be the sum of its daily average negative total managed liabilities and $100 million.

18/ A United States resident is: (a) Any individual residing (at the time the credit is extended) in any State of the United States or the District of Columbia; (b) any corporation, partnership, association or other entity organized therein ("domestic corporation"); and (c) any branch or office located therein of any other entity wherever organized. Credit extended to a foreign branch, office, subsidiary, affiliate or other foreign establishment ("foreign affiliate") controlled by one or more such domestic corporations will not be deemed to be credit extended to a United States resident if the proceeds will be used in its foreign business or that of other foreign affiliates of the controlling domestic corporation(s).

19/ Any banking office located outside the States of the United States and the District of Columbia of a bank organized under domestic or foreign law.

20/ A foreign central bank, or any international organization of which the United States is a member, such as the International Bank for Reconstruction and Development (World Bank), International Monetary Fund, Inter-American Development Bank, and other foreign international, or supranational entities exempt from interest rate limitations under § 217.3(g)(3) of Regulation Q (12 CFR 217.3(g)(3)).

By order of the Board of Governors of the Federal Reserve System, March 14, 1980.

(Signed) Theodore E. Allison

Theodore E. Allison
Secretary of the Board

[SEAL]

TITLE 12--BANKS AND BANKING

CHAPTER II--FEDERAL RESERVE SYSTEM

SUBCHAPTER A--BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

(Docket No. R-0282)

Part 229--CREDIT RESTRAINT

[Subpart C]

Nonmember Commercial Banks

AGENCY: Board of Governors of the Federal Reserve System.

ACTION: Final rule.

SUMMARY: Pursuant to the Credit Control Act (12 U.S.C. §§ 1901 - 1909) as implemented by Executive Order 12201, the Board has adopted provisions requiring commercial banks that are not members of the Federal Reserve System to maintain a non-interest bearing special deposit with the Federal Reserve equal to 10 per cent of the amount by which the total of certain managed liabilities of those banks exceeds the amount of such managed liabilities outstanding during a base period. The purpose of this action is to better control the expansion of bank credit and thereby serve to dampen inflationary forces. The managed liabilities affected by this action include the total of (1) time deposits in denominations of $100,000 or more with original maturities of less than one year; (2) Federal funds borrowings with original maturities of less than one year from U.S. offices of certain depository institutions and from U.S. government agencies; (3) repurchase agreements with original maturities of less than one year on U.S. government and agency securities; and (4) Eurodollar borrowings from foreign banking offices, asset sales to related foreign offices, and foreign office loans to U.S. residents. The special deposit requirement will not apply to borrowings from the United States, principally in the form of Treasury tax and loan account note balances. The 10 per cent special deposit requirement will apply to the amount by which the daily average amount of an institution's total managed liabilities during a deposit computation period exceeds a base amount calculated generally as either the daily average amount of such liabilities outstanding during the base period (February 28 to March 12, 1980) or $100 million, whichever is greater.

EFFECTIVE DATE: The special deposit requirement is effective on marginal total managed liabilities outstanding during the seven-day computation period beginning March 13, 1980, and each seven day period thereafter. The non-interest bearing special deposit for the computation periods beginning March 13, 20, and 27, 1980 must be held during the deposit maintenance period beginning April 10, 1980. Thereafter the special deposit must be held during the seven day maintenance period beginning eight days after the end of the corresponding computation period.

FOR FURTHER INFORMATION CONTACT: Gilbert T. Schwartz, Assistant General Counsel, C. Baird Brown, Attorney, Paul S. Pilecki, Attorney, or Daniel L. Rhoads, Attorney, Legal Division, Board of Governors of the Federal Reserve System, Washington, D.C. 20551 (202/452-3000).

SUPPLEMENTARY INFORMATION: In accordance with the Credit Control Act (12 U.S.C. §§ 1901 - 1909) as implemented by Executive Order 12201, the Board has adopted this Subpart to require certain borrowers consisting of all commercial banks that are not members of the Federal Reserve System to maintain a non-interest bearing special deposit with the Federal Reserve System. This Subpart does not apply to United States branches and agencies of foreign banks that are subject to the Board's marginal reserve requirements (12 C.F.R. § 204.5(f)). Other United States branches and agencies of foreign banks are covered. The amount of the special deposit to be held will be equal to 10 per cent of the amount by which the daily average total of an institution's managed liabilities during a deposit computation period exceeds a base amount. Generally, an institution's base is the daily average amount of the institution's total managed liabilities outstanding during the base period (February 28 to March 12, 1980) or $100 million, whichever is greater. The managed liabilities on which the special deposit requirement will apply include the total of (1) time deposits in denominations of $100,000 or more with original maturities of less than one year; (2) Federal funds borrowings with original maturities of less than one year from U.S. offices of certain depository institutions and from U.S. government agencies; (3) repurchase agreements with original maturities of less than one year on U.S. government and agency securities; and (4) Eurodollar borrowings from foreign banking offices of the same institution or of other banks, asset sales to related foreign offices, and non-member commercial bank foreign office loans to U.S. residents.

Time Deposits of $100,000 or More

Managed liabilities subject to the special deposit requirement include deposits of the following types:

(a) Time deposits of $100,000 or more with original maturities of less than one year; and

(b) Time deposits of $100,000 or more with original maturities of less than one year represented by promissory notes, acknowledgements of advance, due bills, or similar obligations (written or oral) as provided in § 204.1(f) of Regulation D; and

(c) Time deposits of any denomination with remaining maturities of less than one year represented by ineligible bankers' acceptances or obligations issued by a bank's affiliate to the extent that the proceeds are supplied to the bank as provided in § 204.1(f) of Regulation D.

Credit balances of $100,000 or more with original maturities of 30 days or more but less than one year will also be treated as managed liabilities subject to the special deposit requirement. Time deposits subject to the special deposit requirement do not include savings deposits and Christmas club-type deposits.

Federal Funds and Repurchase Agreements

Certain Federal funds borrowings and repurchase agreements of non-member commercial banks are treated as managed liabilities subject to the special deposit requirement. Under this approach, the amount of borrowings with original maturities of less than one year from agencies of the United States and other non-exempt entities (together with other managed liabilities) that exceeds the institution's base, will be subject to the 10 per cent special deposit requirement. The Board believes that exempting Federal funds borrowings from institutions whose liabilities already are subject to Federal reserve requirements from the special deposit requirement is appropriate to facilitate the reserve adjustment process.

Borrowings from the United States government (principally in the form of Treasury tax and loan account note balances), however, will not be regarded as managed liabilities subject to the special deposit requirement. Borrowings with original maturities of less than one year from Federal agencies and instrumentalities such as the Federal Home Loan Bank Board and the Federal Home Loan Banks will be subject to the special deposit requirement.

In the past, the term "bank" has been defined by the Board to include commercial banks, savings banks, savings and loan associations, cooperative banks, credit unions, the Export-Import Bank, and Minbanc Capital Corporation (see 12 C.F.R. § 217.137). Borrowings from all such non-member institutions by non-member commercial banks will be regarded as managed liabilities subject to the special deposit requirement.

Borrowings from domestic offices of organizations that are required by the Board to maintain reserves will not be regarded as managed liabilities subject to the special deposit requirement. The institutions that currently are required to maintain reserves include member banks,

Edge Corporations engaged in the banking business (12 U.S.C. § 615), Agreement Corporations (12 U.S.C. §§ 601-604a), operations subsidiaries of member banks (12 C.F.R. § 204.117), and U.S. branches and agencies of foreign banks with worldwide banking assets in excess of $1 billion (12 U.S.C. § 3105).

Under the Board's action, borrowings in the form of repurchase agreements with original maturities of less than one year involving U.S. government and agency securities also would be regarded as managed liabilities subject to the special deposit requirement. Repurchase agreements entered into with U.S. offices of member banks or organizations that are required by the Board to maintain reserves with the Federal Reserve System would not be regarded as managed liabilities subject to the special deposit requirement. Repurchase agreements entered into by non-member commercial banks with nonexempt entities, such as non-member banks and nonbank dealers, will not be subject to the special deposit requirement if such transactions are intended to provide collateral to nonexempt entities in order to engage in repurchase transactions with the Federal Reserve System Open Market Account.

In order to continue to facilitate the activities of bank dealers in the U.S. government and agency securities markets, and to provide competitive equality between bank and nonbank dealers, the amendment permits non-member commercial banks to deduct the amount of U.S. government and agency securities held by the institution in its trading account from the total amount of its repurchase agreements entered into in determining the amount of its repurchase agreements subject to the special deposit requirement. A trading account represents the U.S. government and agency securities that are held for dealer transactions--i.e., securities purchased with the intention that they will be resold rather than held as an investment. The Board expects that institutions will not reclassify U.S. government and agency securities held in their investment or other accounts to their trading accounts for the purpose of avoiding special deposit requirements.

Managed liabilities subject to the 10 per cent special deposit requirement also will include any obligation that arises from a borrowing for one business day from a dealer in securities whose liabilities are not subject to the reserve requirements of the Federal Reserve Act of proceeds of a transfer of deposit credit in a Federal Reserve Bank (or other immediately available funds), received by such dealer on the date of the loan in connection with clearance of securities transactions.

Eurodollars

The Board also has included the Eurodollar borrowings of non-member commercial banks as managed liabilities subject to the special deposit requirement. Consequently, the amount of Eurodollars (together with other managed liabilities) of a bank that exceeds the institution's base will be subject to the 10 per cent special deposit requirement. Such Eurodollars include the institution's daily average balance of (1) borrowings with original maturities of less than one year from foreign offices of other banks and institutions that are exempt from interest rate limitations pursuant to § 217.3(g) of Regulation Q; (2) net balances due from an institution's domestic offices to its foreign offices; (3) liabilities of an institution's foreign branches to the extent that the branches hold assets (including participations) acquired from its domestic offices or has credit outstanding from the bank's foreign offices to U.S. residents.

Computation and Maintenance of Non-Interest Bearing Special Deposits

The amount of special deposits that a bank will be required to maintain each week will be determined by the amount by which the total of the institution's managed liabilities during a corresponding seven-day computation period exceeds its base of managed liabilities. The base amount for a bank that is a net borrower of managed liabilities is $100 million, or the daily average amount of its managed liabilities during the fourteen-day base period ending March 12, 1980, reduced by an adjustment for the reduction in its foreign lending from domestic offices, whichever is greater. The adjustment for any given computation period is based on the difference between the sum of its gross loans to non-United States residents and gross balances due from foreign offices of other institutions, and the lowest gross total of such lending for any computation week beginning after March 12, 1980. That difference is then rounded down to the largest lower multiple of $2 million and subtracted from the daily average of managed liabilities for the base period. For example, if a bank has $125 million of average managed liabilities and $40 million in gross lending to foreign borrowers and institutions during the base period, and $35 million of gross lending to foreign borrowers and institutions during the week beginning March 13, 1980, its base for that computation week would be $125 million minus $4 million = $121 million (where $4 million is derived from $40 million minus $35 million = $5 million which is rounded to $4 million). If in a later week the gross lending to foreign borrowers and institutions rises to $45 million, the base remains at $121 million. If in a later week the gross lending to foreign borrowers and institutions falls to $10 million, the reduction would be $40 million minus $10 million = $30 million (no rounding needed), thus the calulated base would be $125 million minus $30 million = $95 million, but the reported base amount would be $100 million,

which is a permanent floor for the base amount. The special deposit would be 10 per cent of the difference between its managed liabilities for the computation week and the $100 million base.

Rounding the reduction in the base will serve to minimize the impact of small repayments or reductions in the daily average gross loans to non-United States residents and balances due from foreign offices of other institutions. The reduction in such lending below the daily average for the base period ending March 12, 1980 will only reduce the base in increments of $2 million. This approach will enable institutions to receive ordinary repayments of foreign loans without being required to relend such funds immediately to avoid a reduction in the base.

For an institution that is a net lender of managed liabilities (that is, the sum of its managed liabilities is negative because its net Eurodollar loans to its foreign offices are greater than the total of its large time deposits, Federal funds purchased, repurchase agreements, and borrowed Eurodollars), its base will be the algebraic sum of its managed liabilities during the base period ending March 12, 1980, and $100 million. For example, if an institution has negative $150 million of managed liabilities during the base period, its base will be negative $50 million, and special deposit requirements will apply to the amount of its total managed liabilities above that amount. If such an institution maintained a daily average of total managed liabilities during a computation period of negative $30 million, it would be required to maintain the 10 per cent special deposit requirement against $20 million of managed liabilities during the reserve maintenance period.

The special deposit must be maintained in collected funds in the form of U.S. dollars. Maintenance of a special deposit does not entitle a non-member bank to Federal Reserve services.

Restraint on growth in money and credit must be a fundamental part of the process of subduing inflationary forces. Growth in bank credit in recent months has been excessive. Therefore, the Board has adopted this special deposit requirement based on managed liabilities issued by nonmember banks. This requirement will impose restraint on the sources of funds that banks typically have used to finance the expansion of bank credit. The nonmember bank special deposit requirement complements the additional restraint the Board has imposed on similar liabilities of member banks. In the absence of this constraint, nonmember banks could continue to extend credit with few limitations. Borrowers that could not be accommodated at a member bank could turn to a nonmember bank, thereby undermining restraint on bank credit. Containing the growth of bank credit financed in large part by managed liabilities at nonmember banks will thus contribute to dampening inflationary forces.

These actions are being taken to help curb the expansion of bank credit, thereby dampening inflationary pressures. The Board believes that it is in the national interest to achieve this objective as quickly as possible, and that publication of this rule for comment or any delay in its effective date would lead to rapid increases in extensions of credit that would not be subject to the regulation and would frustrate its purpose. The Board therefore finds for good cause that the notice, public procedure, and deferral of effective date provisions of 5 U.S.C. § 553(b) with regard to these actions are impracticable and contrary to the public interest.

Pursuant to its authority under the Credit Control Act (12 U.S.C. §§ 1901 - 1909) the Board hereby adopts Subpart C of its regulation regarding Credit Restraint (12 C.F.R. § 229) effective March 14, 1980, 1980, as follows:

SECTION 229.21--AUTHORITY, PURPOSE, AND SCOPE

(a) Authority. This Subpart is issued by the Board of Governors of the Federal Reserve System pursuant to the Credit Control Act (12 U.S.C. §§ 1901 - 1909), as implemented by Executive Order 12201.

(b) Purpose and Scope. This Subpart is intended to curb inflation by controlling the expansion of credit extended by commercial banks that are not members of the Federal Reserve System that is supported by extensions of credit to those banks in the form of managed liabilities.

SECTION 229.22--DEFINITIONS

(a) For the purposes of this Subpart, the terms "credit," and "extension of credit" shall have the meanings given them in the Credit Control Act. In addition, the following definitions apply.

(b) "Covered bank" means any commercial bank that is not a member of the Federal Reserve System, or required to maintain reserves under the Federal Reserve Act.

(c) "Member bank" means any bank that is a member of the Federal Reserve System.

SECTION 229.23--REPORTS

Each covered bank shall file with the Federal Reserve Bank for the Federal Reserve district in which its head office is located such reports as shall be required in connection with the maintenance of a special deposit under this Subpart.

SECTION 229.24--MAINTENANCE OF SPECIAL DEPOSIT

(a) During the seven-day deposit maintenance period beginning April 10, 1980, each covered bank shall maintain a non-interest bearing special deposit equal to 10 per cent of the sum of the amounts by which the daily average of its total managed liabilities during each of the seven-day computation periods beginning March 13, 20, and 27 exceeds its managed liabilities base as determined in accordance with paragraph (b). During the seven-day deposit maintenance period beginning April 17, 1980, and each deposit maintenance period thereafter, each covered bank shall maintain a non-interest bearing special deposit equal to 10 per cent of the amount by which the daily average of its total managed liabilities during the seven-day computation period ending eight days prior to the beginning of the corresponding seven-day deposit maintenance period exceeds its managed liabilities base as determined in accordance with paragraph (b). A covered bank's managed liabilities are the total of the following:

(1)(A) time deposits of $100,000 or more with original maturities of less than one year;

(B) time deposits of $100,000 or more with original maturities of less than one year representing borrowings in the form of promissory notes, acknowledgments of advance, due bills, or similar obligations as provided in ¶ 204.1(f) of Regulation D; and

(C) time deposits with remaining maturities of less than one year represented by ineligible bankers' acceptances or obligations issued by a bank's affiliate, as provided in ¶ 204.1(f) of Regulation D. However, managed liabilities do not include savings deposits, or time deposits, open account that constitute deposits of individuals, such as Christmas club accounts and vacation club accounts that are made under written contracts providing that no withdrawal shall be made until a certain number of periodic deposits have been made during a period of not less than three months;

(2) any obligation with an original maturity of less than one year that is issued or undertaken as a means of obtaining funds to be used in its banking business in the form of a promissory note, acknowledgment of advance, due bill, ineligible bankers' acceptance, repurchase agreement (except on a U.S. or agency security), or similar obligation (written or oral) issued to and held for the account of a domestic banking office or agency[1/] of another commercial bank or trust company that is not required to maintain reserves pursuant to Regulation D, a savings bank (mutual or stock), a building or savings and

1/ Any banking office or agency in any State of the United States or the District of Columbia of a bank organized under domestic or foreign law.

loan association, a cooperative bank, a credit union, or an agency of the United States, the Export-Import Bank of the United States, Minbanc Capital Corporation and the Government Development Bank for Puerto Rico;

(3) any obligation with an original maturity of less than one year that is issued or undertaken as a means of obtaining funds to be used in its banking business in the form of a repurchase agreement arising from a transfer of direct obligations of, or obligations that are fully guaranteed as to principal and interest by, the United States or any agency thereof that the institution is obligated to repurchase except repurchase agreements issued to a domestic banking office or agency of a member bank, or other organization that is required to maintain reserves under Regulation D pursuant to the Federal Reserve Act,[2/] to the extent that the amount of such repurchase agreements exceeds the total amount of United States and agency securities held by the covered bank in its trading account;

(4) any obligation that arises from a borrowing by a covered bank from a dealer in securities that is not a member bank or other organization that is required to maintain reserves pursuant to Regulation D,[2/] for one business day, of proceeds of a transfer of deposit credit in a Federal Reserve Bank (or other immediately available funds), received by such dealer on the date of the loan in connection with clearance of securities transactions;

(5) borrowings with an original maturity of less than one year from foreign offices of other banks and from institutions that are exempt from interest rate limitations pursuant to § 217.3(g) of Regulation Q;

(6) net balances due from the covered bank's domestic offices to its foreign branches;

(7) liabilities of a foreign branch of the covered bank to the extent that the foreign branch holds assets (including participations) acquired from the covered bank's domestic offices; and

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2/ Edge Corporations engaged in banking, Agreement Corporations, operations subsidiaries of member banks and U.S. branches and agencies of foreign banks with worldwide banking assets in excess of $1 billion.

(8) liabilities of a foreign branch of the covered bank to the extent that it has credit outstanding from its foreign branches to U.S. residents[3/] (other than assets acquired and net balances due from its domestic offices). Provided, That this paragraph does not apply to credit extended (1) in the aggregate amount of $100,000 or less to any United States resident, (2) by a foreign branch which at no time during the computation period had credit outstanding to United States residents exceeding $1 million, (3) under binding commitments entered into before May 17, 1973, or (4) to an institution that will be maintaining reserves on such credit under paragraphs (c) or (f) of section 204.5 of Regulation D or under Regulation K.

(b) Managed liabilities base. During the seven-day deposit computation period beginning March 13, 1980, and during each seven-day deposit computation period thereafter, the managed liabilities base of a covered bank shall be determined as follows:

(1) For a covered bank that, on a daily average basis, is a net borrower of total managed liabilities during the fourteen-day base period ending March 12, 1980, its managed liabilities base shall be the daily average of its total managed liabilities during the base period reduced by the amount by which its lowest daily average of gross loans to non-United States residents[3/] and gross balances due from foreign offices of other institutions[4/] or institutions the time deposits of which are exempt from the rate limitations of Regulation Q pursuant to § 217.3(g) thereof[5/] outstanding during any computation period after March 12, 1980, is lower than the daily average amount of such loans and balances outstanding during the base period. The amount of the reduction shall be rounded down to the largest lower multiple of $2 million.

3/ A United States resident is: (a) any individual residing (at the time the credit is extended) in any State of the United States or the District of Columbia; (b) any corporation, partnership, association or other entity organized therein ("domestic corporation"); and (c) any branch or office located therein of any other entity wherever organized. Credit extended to a foreign branch, office, subsidiary, affiliate or other foreign establishment ("foreign affiliate") controlled by one or more such domestic corporations will not be deemed to be credit extended to a United States resident if the proceeds will be used in its foreign business or that of other foreign affiliates of the controlling domestic corporation(s).

4/ Any banking office located outside the States of the United States and the District of Columbia of a bank organized under domestic or foreign law.

5/ A foreign central bank, or any international organization, of which the United States is a member, such as the International Bank for Reconstruction and Development (World Bank), International Monetary Fund, Inter-American Development Bank, and other foreign international, or supranational entities exempt from interest rate limitations under § 217.3(g)(3) of Regulation Q (12 C.F.R. § 217.3(g)(3)).

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However, in no event will the managed liabilities base for a covered bank that was a net borrower of managed liabilities during the fourteen-day base period ending March 12, 1980, be less than $100 million.

(2) For a covered bank that, on a daily average basis, is a net lender of total managed liabilities during the fourteen-day base period ending March 12, 1980, its managed liabilities base shall be the sum of its daily average negative total managed liabilities and $100 million.

(c) The special deposit shall be maintained at the Federal Reserve Bank to which the covered bank reports. The special deposit must be maintained in collected funds in the form of U.S. dollars.

SECTION 229.25--PENALTIES

For each willful violation of this Part, the Board may assess against any creditor, or officer, director or employee thereof who willfully participates in the violation, a maximum civil penalty of $1,000. In addition, a maximum criminal penalty of $1,000 and imprisonment of one year may be imposed for willful violation of this Part.

Board of Governors of the Federal Reserve System, effective March 14, 1980.

(Signed) Theodore E. Allison

Theodore E. Allison
Secretary of the Board

[SEAL]

TITLE 12--BANKS AND BANKING

CHAPTER II--FEDERAL RESERVE SYSTEM

SUBCHAPTER A--BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

(Docket No. R-0281)

Part 229--CREDIT RESTRAINT

[Subpart B]

Short Term Financial Intermediaries

AGENCY: Board of Governors of the Federal Reserve System.

ACTION: Final rule.

SUMMARY: Pursuant to the Credit Control Act (12 U.S.C. §§ 1901-1909) as implemented by Executive Order 12201, the Board has adopted provisions requiring money market funds and other similar creditors to maintain a special non-interest bearing deposit with the Federal Reserve equal to 15 per cent of the amount by which the investment assets of these creditors exceeds their investment assets on March 14, 1980. Special non-interest bearing deposits shall be maintained at the Federal Reserve Bank of the district in which the creditor maintains its principal place of business. The purpose of this action is to control inflation by limiting the expansion of short-term credit offered by such financial intermediaries.

EFFECTIVE DATE: March 14, 1980.

FOR FURTHER INFORMATION CONTACT: Gilbert T. Schwartz, Assistant General Counsel, Lee S. Adams, Senior Attorney, C. Baird Brown, Attorney, or Daniel L. Rhoads, Attorney, Legal Division, Board of Governors of the Federal Reserve System, Washington, D.C. 20551 (202/452-3000).

SUPPLEMENTARY INFORMATION: In accordance with the Credit Control Act (12 U.S.C. §§ 1901-1909) as implemented by Executive Order 12201, the Board has adopted this Subpart of its Credit Restraint regulation to require creditors, consisting of investment companies commonly regarded as money market funds and certain common trust funds of banks that invest in short term assets (short term investment funds) to hold a non-interest bearing special deposit with the Federal Reserve against increases in their total assets. The amount of the special deposit that must be held shall be equal to 15 per cent of the amount by which the assets of the creditor exceed the amount of such assets in the creditor's portfolio on March 14, 1980. The special deposit must be made in collected funds in U.S. dollars.

A creditor will be covered if its investment portfolio primarily consists of short-term securities, deposits, or other instruments with original or remaining maturities of 13 months or less through which it extends credit to banks, federal, state or local governmental units or agencies thereof, any corporation, partnership or other business entity, or any person. Covered creditors include both open and closed-end management companies and unit investment trusts. A series of shares or units of a registered investment company is a covered creditor if the investment assets which are included in the valuation of the shares or units in the series primarily have maturities of less than 13 months. Common trust funds of banks and trust companies are also included unless all moneys contributed to them are held by the bank or trust company incidentally to the management of other trust assets. Collective investment funds consisting of funds of retirement, pension, or other tax exempt trusts are not covered.

A covered creditor, other than a unit investment trust or series of units of such a trust ("Non-unit Creditor"), that possesses assets on March 14, 1980, shall file a base report with a Federal Reserve Bank by April 1, 1980. A Non-unit Creditor that acquires or holds assets or trust moneys that cause it to become a covered creditor after March 14, 1980, shall file a base report, within two weeks after it becomes a covered creditor. The base report will state the amount of the Non-unit Creditor's covered credit, which is defined as the total amount of its investment assets and other deposits plus accrued interest, held as of March 14, 1980, whether or not it was a covered creditor at that time. If the covered creditor was not in existence on March 14, 1980, its base amount is zero.

Thereafter, each Non-unit Creditor shall file a report monthly stating the daily average amount of its net assets during each reporting period by the 21st day of the month in which the reporting period ends. The reporting periods will run from the 15th day of each month to the 14th day of the following month. For example, the first reporting period will run from March 15 to April 14, 1980, and the second from April 15 to May 14, 1980. The report for the first reporting period must be filed by April 21, 1980, and for the second by May 21, 1980. Based upon this report, a covered creditor is required to maintain a special non-interest bearing deposit with the Federal Reserve Bank in the District in which its principal place of business is located equal to 15 per cent of the amount by which the reported average of covered credit exceeds the reported base. The special deposit shall be maintained during the period beginning on the first Thursday of the first full calendar month following the period for which the report was filed and ending on the day prior to the first Thursday of the next month. For example, the special deposit based upon the first report shall be held beginning May 1, 1980 and continue through June 4, 1980, at which time a special deposit based upon the second report shall be required.

A unit investment trust or series of units of such a trust ("Unit Creditor") that holds investment assets on March 14, 1980, need not file reports or maintain special deposits, as their assets are fixed as of the date they are transferred to the trust and will not increase after March 14, 1980. A Unit Creditor that is established, by the transfer of investment assets to the trustee, after March 14, 1980, must file immediately upon acquisition of assets by the trust, a base report stating the amount of covered credit held by the trust. Each such Unit Creditor must maintain a special deposit equal to 15 per cent of the covered credit it holds. The special deposit must be maintained during the period beginning with the acquisition of assets by the Unit Creditor and ending on the day prior to termination of the trust pursuant to the terms of the trust agreement. A Unit Creditor is only required to file reports and maintain deposits if, at its inception, its assets primarily have original or remaining maturities of less than 13 months. A Unit Creditor whose assets at its inception had longer maturities, but whose asset maturities fall below 13 months as the termination of the trust approaches is not required to report or to maintain a special deposit.

For a covered creditor that is a series of shares or units of a registered investment company, reports should be filed and deposits maintained by the registered investment company. If the entire investment company which issues such a series is a covered creditor, the entire company may file a single report and maintain a single deposit. Otherwise the investment company must file a separate report and maintain a separate deposit for each series that is a covered creditor. Maintenance of a special deposit at a Federal Reserve Bank does not entitle covered creditors to Federal Reserve services.

Recent strong demands for money and credit, generated in part by inflationary forces, have brought heavy pressure on credit and financial markets generally, with varying impacts on particular sectors of the economy. The creditors covered by this Subpart act as financial intermediaries, accepting funds from investors who desire a stable, liquid, high income investment, and extending credit primarily through the purchase of money market instruments. Rapid expansion of credit extended by these creditors has contributed to the pressures by facilitating borrowing in the markets for Eurodollars, commercial paper, bankers acceptances, and other short-term liquid instruments. Moreover, the rapid expansion of such creditors has tended to impede reasonable flows of credit to other sectors including housing, small businesses, and farmers. Restraint on the growth of money market funds and similar creditors will enable funds to flow in more usual measure to productive uses, and thus contribute to dampening inflationary forces.

These actions are being taken to curb inflationary pressures. The Board believes that it is in the national interest to achieve this objective as quickly as possible, and that publication of this rule for comment or any delay in its effective date would lead to rapid increases in extensions of credit that would not be subject to the regulation and would frustrate its purpose. The Board therefore finds for good cause that further notice, public procedure, and deferral of effective date provisions of 5 U.S.C. § 553(b) with regard to these actions are impracticable and contrary to the public interest.

Pursuant to its authority under the Credit Control Act (12 U.S.C. §§ 1901-1909) the Board hereby adopts Subpart B of its Credit Restraint regulation (12 C.F.R. § 229) effective March 14, 1980, as follows:

SECTION 229.11--AUTHORITY, PURPOSE, AND SCOPE

(a) Authority. This Subpart is issued by the Board of Governors of the Federal Reserve System pursuant to the Credit Control Act (12 U.S.C. §§ 1901 - 1909), as implemented by Executive Order 12201.

(b) Purpose and Scope. This Subpart is intended to curb inflation generated by the extension of credit by certain of those financial intermediaries which are not subject to either the amendments of law effected by Pub. L. 89-597, as amended, or section 19 of the Federal Reserve Act, as amended (12 U.S.C.§461), and which are primarily engaged in the extension of short-term credit, specifically money market funds and other similar creditors.

SECTION 229.12--DEFINITIONS

(a) For the purposes of this Subpart, the terms "credit," "creditor," and "extension of credit" shall have the meanings given them in the Credit Control Act. In addition, the following definitions apply.

(b) "Base" means the amount[1/] of covered credit held by a covered creditor as of the close of business on March 14, 1980.

(c) "Covered credit" means any extension of credit originated through the acquisition of a security, deposit, or other instrument, including but not limited to domestic and Eurodollar certificates of deposit, U.S. Treasury bills, repurchase agreements, commercial paper, bankers acceptances, and state and local government obligations, and any interest accrued thereon.

1/ Assets should be valued for purposes of this Subpart by the same procedure used by a registered investment company to value assets in calculating net share or unit value under the Investment Company Act of 1940 and rules promulgated thereunder.

(d) "Covered creditor" means any creditor (1) that is (A) an investment company registered with the Securities and Exchange Commission under the Investment Company Act of 1940, (B) any series of shares or units of such a company, or (C) any common trust fund or similar fund maintained by a bank or trust company exclusively for the collective investment and reinvestment of moneys contributed thereto by the bank or trust company in its capacity as a trustee, unless all moneys contributed thereto are held incidentally to the management of other trust assets; and (2) whose investment portfolio consists primarily of securities, deposits or other instruments, including but not limited to domestic and Eurodollar certificates of deposit, U.S. Treasury bills, repurchase agreements, commercial paper, and state and local obligations with maturities of 13 months or less. However, a unit investment trust is only a covered creditor if its investment portfolio consists primarily of securities, deposits, or other instruments with maturities of 13 months or less[2/] at the time the unit investment trust acquires those assets.

(e) "Security" means any security as defined in the Securities Act of 1933.

(f) "Unit investment trust" means any unit investment trust as defined in the Investment Company Act of 1940, or a series of units of such a trust.

SECTION 229.13--REPORTS

(a) Each covered creditor except a unit investment trust shall file a base report and periodic reports. The base report shall state the amount of the covered creditor's base and shall be submitted no later than April 1, 1980, or in the case of a covered creditor that becomes a covered creditor after March 14, 1980, within two weeks of acquiring or holding assets or accepting trust moneys that cause it to become a covered creditor. Periodic reports shall be filed monthly for each period running from the 15th day of each calendar month to the 14th day of the following month, or in the case of a covered creditor that becomes a covered creditor after March 14, for each full period after it becomes a covered creditor. These reports shall be submitted by the 21st day of the month in which the reporting period ends, and shall state the amount by which the average of the daily amounts of covered credit outstanding during the reported period exceeds the base.

2/ This includes variable rate securities, deposits or other instruments with longer nominal maturities but with interest rates subject to adjustment at intervals shorter than 13 months.

(b) A covered creditor that is a unit investment trust establis after March 14, 1980, shall file a base report stating the amount of covered credit it holds. This report shall be filed immediately upon acquisition of investment assets by the unit investment trust. Each such covered creditor shall also notify the appropriate Federal Reserve Bank two weeks before termination of the trust stating the projected date of termination of the trust.

(c) All reports shall be filed with the Federal Reserve Bank in the District where the covered creditor has its principal place of business.

SECTION 229.14--MAINTENANCE OF SPECIAL DEPOSIT

(a) Each covered creditor that is not a unit investment trust shall maintain a non-interest bearing special deposit equal to 15 per cent of the amount by which the average of the daily amounts of its covered credit outstanding during each reporting period exceeds its base. The corresponding period during which the special deposit shall be maintained begins on the first Thursday of the first full calendar month following the period for which the report was filed and ends on the day prior to the first Thursday of the following month. The special deposit shall be maintained at the Federal Reserve Bank to which the covered creditor reports.

(b) Each covered creditor that is a unit investment trust established after March 14, 1980, shall maintain a non-interest bearing special deposit equal to 15 per cent of the covered credit it holds as of the date it acquires investment assets. This special deposit shall be maintained during the period beginning with the day the covered creditor acquires assets consisting of covered credit and ending one day prior to final distribution of trust assets by the Trustee pursuant to the terms of the trust agreement. The special deposit shall be maintain at the Federal Reserve Bank to which the covered unit investment trust reports. Upon two weeks notice, the special deposit will be returned to the trustee one day prior to maturity or final distribution pursuant to the terms of the trust agreement.

(c) Special deposits shall be maintained in collected funds in the form of U.S. dollars.

SECTION 229.15--PENALTIES

For each willful violation of this Subpart, the Board may assess against any creditor, or officer, director or employee thereof who willfull

participates in the violation, a maximum civil penalty of $1,000. In addition, a maximum criminal penalty of $1,000 and imprisonment of one year may be imposed for willful violation of this Subpart.

Board of Governors of the Federal Reserve System, effective March 14, 1980.

(signed) Theodore E. Allison
Theodore E. Allison
Secretary of the Board

[SEAL]

Mr. SCHULTZE. Mr. Chairman, I do not have a prepared text. I would like to speak relatively briefly, I hope, to the major elements of this program and try to put the program in the context of the economic situation which gave rise to it.

In the last 7 to 8 weeks, economic conditions in the United States have worsened, and in a dangerous way that requires the Federal Government to take immediate and strong corrective action.

As you noted, Mr. Chairman, inflation in January and February was running in the 18 to 20 percent range. During those same months interest rates were soaring, rising by 3 to 4 percentage points in the short market, and 2 to 2½ percentage points in the long. The bond market, for all practical purposes, disappeared. There appeared to be an unwillingness, because of the great uncertainty about the future, to commit on a long-term fixed basis.

Not only the United States, but other countries, are being faced with very substantial inflation partly, although not solely, as a consequence of the direct and indirect impact of the 125 percent in OPEC oil prices. In the last 2 reported months, for example, the annual rate of wholesale price inflation in Japan was 32 percent. In the United Kingdom it was 28 percent. In Italy it was 35 percent. And even in Germany it was 13 percent, which is a major increase in the German rate.

Now, these are wholesale price increases, and reflect the same kinds of things that are going on here.

With respect to the United States, the President believes—and his advisers strongly agree—that it was essential to take very firm corrective action to deal with this kind of a situation. In many ways, the U.S. economy is in essentially a strong position. We have not built up major imbalances in our economy in the form of inventory excesses, major shortages, and financial weaknesses. But that economy could be severely weakened if no action were taken in the face of these kinds of developments.

It is clear that in the early part of this year inflationary expectations took a leap forward and, if left unchecked, could have set in motion a new longer term inflationary spiral of substantial magnitude that could take another decade to get rid of. In turn, the effect of those kinds of expectation on credit markets tends to lead to self-justifying, self-fulfilling kinds of situations. Interest rates are expected to rise; this leads to a further rise in interest rates and then bringing somebody else in with the belief that interest rates are going to rise further, which leads to more borrowing and, in turn, if left alone, to the potentiality of a violent credit crunch and severe economic distortions.

Let me turn, if I may, to economic developments in more detail, to underline the kind of situation which the President was facing. Why the sharp worsening of inflation? Why the disturbances in credit markets? Why the soaring interest rates during the early part of this year?

First, we start with the fact that the American economy, measured in terms of the usual kind of indicators, was substantially stronger than expected in the early part of this year. The long-heralded recession did not materialize. In Januay and February, taken together, retail sales were quite strong. In February, for example, retail sales at an annual rate were some 14 percent over the fourth quarter level, significantly more than inflation among the kinds of goods that go into those retail sales. Payroll employment in February was up 500,000 over December.

In January, new orders for durable goods were 6½ percent above the fourth quarter average—not annual rates. On defense, capital goods orders were up by about the same 6½ percent during the same period.

The consumer saving rate, possibly at least fueled by inflationary expectations, had sunk to some 3 percent, the lowest in almost 30 years. And while housing and autos were weak and are weak, the recession did not appear. The economy in the first quarter still appears to be moving ahead, and the first quarter is likely to show an increase rather than the earlier forecast, the rather universally forecast, decrease in overall economic activity.

Second, as I indicated in terms of the totals earlier, there was a significant speedup in inflation in the first 2 months of this year. In 1979, the accelertion of inflation to 13 percent, as measured by the Consumer Price Index, had been heavily concentrated in the direct energy goods and services, in housing and morgage interest rates; and earlier in 1979, in meat prices.

Inflation in other areas of consumer prices in 1979 hovered in the 7 to 7½ percent range. In December and January the Consumer Price Index took a leap up from a 13 percent rate of increase to 16 to 18 percent rate of increase. There were huge increases in energy prices and in mortgage interest rates, as reflected in the CPI.

But, dangerously, there were also significant increases outside of the food, direct energy, and housing areas. Outside of those areas, the rate of inflation popped up from 7 and 7½ percent to 11 and 12 percent during December and January in the Consumer Price Index.

In the Producer Price Index, outside, again, of the direct impact of energy, January and February price increases averaged some 15 percent, substantially higher than had been going on in the prior year.

So, while the bad news about inflation early this year was importantly in energy and mortgage interest rates, there also appeared to be a significant spread of inflation to areas outside of those two.

Partly, this is undoubtedly the response to the indirect impact of oil price increases. By "indirect impact," I mean not gasoline prices or heating oil prices, but higher petroleum feedstocks coming through in terms of higher prices for plastics, synthetic fibers, and all the rest. Those indirect effects we estimate to be perhaps equal to adding 1½ to 2 percent to the consumer price level. That is, given the OPEC oil price increases, what the impact on the consumer price level from these indirect impacts would be.

We don't know when those get passed through. We have no mechanism to trace it through directly. But it is quite reasonable to believe that a significant part of the acceleration in consumer prices was due to these indirect effects.

There were other major cost increases in 1979 due to relatively poor productivity performance—I shouldn't say "relatively poor"—I mean abysmally poor productivity performance in the U.S. economy in 1979. And it is quite possible and quite likely that the combination of a stronger economy and heightened inflationary expectations combined to make it possible to pass through, and perhaps to more than pass through the indirect impact of higher energy prices and the impact of poor productivity performance on costs.

In summary, therefore, we had in the early months of this year—

we have—a situation in which a sudden new acceleration of inflat
has occurred, threatening to spill out from energy and housing to
other sectors of the economy. Simultaneously, since mid-January,
terest rates have shot up at an unprecedented rate.

And what are the reasons for that? Let's clearly relate it to
other factors discussed earlier. A stronger economy: Undoubtedly,
bond market, late in 1979, had built into its own forecasts an expec
tion of an early downturn in the economic activity, and the cor
quent decline in short-term interest rates. That did not occur.

That led to a reversal of expectations and attitudes. There wa
turnaround in business borrowing. Business loans at banks and s
of commercial paper combined rose at a 26-percent annual rate
the third quarter of 1979, then dropped to only a 6-percent rate
expansion in the fourth quarter, quite consistent with the concept
an economy beginning to slow down. But, lo and behold, that rate
expansion popped back up to an annual rate of 28 percent in
month of January and continued on at about that rate in the mo
of February.

The inflation rate of 18 to 20 percent obviously had a major imp
on long-term expectations in the bond market. The interpretation
the 1980 budget contributed to that. The 1980 budget, when it came
this January, had expenditures some $32 billion higher than had b
forecast 1 year ago in January. Now, to the dime almost, that
exactly the impact of the higher-than-expected inflation rate. Bu
can talk until I am blue in the face and say that is the case—and it i
nevertheless it is a very large number, $32 billion additional on
1980 budget, and that had an impact on expectations in the mark

Additionally, an apparent belief that there was a new defense m
underway and that defense expenditures were going to rise very s
stantially, very substantially more than in the President's budg
had an effect. Again, this is a wrong perception. But whether right
wrong, it was a perception which contributed to these expectations.

As a consequence of all of this—the stronger economy, a speed
in inflation, the interpretation of the budget, the feeling about
fense—all of this led to a situation in which long-term bond pri
began to fall rapidly, leading, in turn, to a diversion of borrow
from long term to short term, helping then, in turn, to drive up sho
term rates.

And all of this fed on itself, as I indicated earlier. If one expe
the rates to go up in the next 2 to 3 weeks, well, then cover yours
go in and borrow now rather than later—which contributes to
of this.

In turn, finally, this kind of a situation has had a strong impac
and not a good impact—on the ability of thrift institutions to furn
funds to the mortgage market as those very high short-term ra
press up against the more stable earnings from longer term mortg
portfolios.

And so we were facing an economy in which the interaction of
based cost increases, stronger than expected economic activity, an
sharp revision of earlier recession forecasts in financial markets, co
bined to generate a dangerous and, to some extent, self-feeding mo
ment in actual prices and interest rates and sharply raised expectati
about future prices and interest rates.

Mr. Chairman, if I might philosophize just a little bit, it is likely that one characteristic of a world of high and variable inflation rates is that perceptions about the future tend to get torn loose from reality a little bit. But those perceptions, in turn, can influence reality, and sometimes in a dangerous way. When inflation is at a low and stable level, the fears about the future are difficult to excite and the real facts of today tend to govern.

But when inflation is in double digits and rising, then uncertainty about the future of the economy's measuring rod, which permeates almost everything we do by way of future planning, uncertainty about the future of that measuring rod begins to dominate, and it is easy to excite fears about the future. Fears of future inflation, rather than simply the current facts about credit demand, spending, and the like begin to influence market behavior more and more.

It is absolutely essential to stop this kind of development in its tracks. It is critical to convince people that the Government will indeed take the painful steps necessary to control inflation. It is necessary to stop the cycle of expectations in the credit markets and to calm inflationary expectations in the economy.

And finally, it turned out that the situation was such it was also necessary to give the Federal Reserve additional tools to control credit in order to restrict credit in more effective ways and in ways that take more account of special problems in thrift institutions, special problems of small business and farmers, and others who are particularly hard hit by tight credit.

With this background, Mr. Chairman, the President's program consists of five elements, four of them immediate and one of them longer term:

One, the budget. Balance the 1981 budget, cut spending substantially;

Two, credit. Restrict the growth of credit with both general and selective controls;

Three, wage and price standards. Substantially expand the monitoring capability of the Government over the voluntary price standards and wage standards, and do it on an industry by industry basis;

Four, energy. Levy a gasoline conservation fee on imports equivalent to 10 cents a gallon on gasoline; and

Five, to pursue and to get ourselves into a position to strengthen our longer term anti-inflation programs.

Let me turn briefly to each of these elements, Mr. Chairman. While I think you are familiar with each of them, I would like to tick them off, if I might.

With respect to the budget, the key point is to balance the budget in 1981. To get there we need significant rescissions in budget authority in 1980 and major cuts in 1981. Within the next several weeks, as soon as the detail work can be complete, the Office of Management and Budget will be submitting to the Congress a substantial number of rescissions for 1980, which will have a small spending impact on 1980 since the year is half over, but will be a significant component of the reductions in 1981.

That new budget submission will also cut spending in 1981 by more than $13 billion. We will ask the Congress for legislation to provide

withholding on interest and dividends, which should yield about $
billion in additional revenues in 1981. Together with the reestimat
of the economic situation, all of this should lead to a budget in 19
ranging from a balance to a $3 billion surplus, and this is without a
revenues from the gasoline conservation fee.

As I indicated, the President will submit the details in the next
weeks. Let me note, Mr. Chairman, if I might, that this is a maj
move toward fiscal restraint. There has been a good deal of criticis
that the 1980 budget is still fairly unrestrained, even if the 19
budget is moving to restraint. If you look at the numbers carefull
this is not the case.

With the new measures the President has proposed, on a quarter
basis the Federal budget will shift by some $30 billion toward r
straint over the four quarters of 1980. Or, to say it another way,
you calculate revenues and expenditures at a constant 6 percent une
ployment rate, so that you then have the impact of the budget on t
economy rather than the impact of the economy on the budget, a
measure the shift toward restraint in that 6 percent unemployme
budget, you have a $30 billion shift toward restraint during calend
year 1980, and a significant further shift in 1981.

So that even though looked at on a unified budget fiscal year bas
most of this restraint appears to come in fiscal 1981, looked at quart
by quarter over the 2-year period you get a substantial move towa
restraint through this year.

Let me note, if I might, Mr. Chairman, that of course a lot of this
going to depend upon congressional cooperation. This is a joint effo
to provide for balancing the budget. And on the basis of the exper
ence we have had to date, I am confident that there will be substanti
cooperation and that this job will get done in terms of the budg
resolutions, appropriations bills, and authorization legislation th
will be passed this session.

But let me note that in any event, the President will use all t
powers at his command to enforce that budget balance. If necessar
he will use his veto power on budget-busting appropriations or oth
matters. He will use the limited powers he has under the Budget R
form Act for deferrals and to submit rescissions. And if evidenc
shows that this is not working, he will be prepared to ask for a tem
porary grant of powers increasing his ability to restrain budg
spending.

Let me now turn, if I may, to the credit area. There are three maj
sets of actions which go together with the budget restraint:

First, the President invoked the Credit Control Act of 1969. Wit
that act invoked, the Federal Reserve will apply restraints to co
sumer credit in areas outside of autos, housing, and related credit. R
straints will apply principally to revolving credit cards, check ove
drafts, and personal loans. To do this, a 15-percent marginal reserv
requirement will be placed upon any expansion in consumer credi
making it more expensive to extend consumer credit and thereby lea
ing to a situation in which major credit extenders will have to ration
by various means.

Second, a voluntary credit restraint program was instituted by th
Federal Reserve. The voluntary controls target a national growth ra

for business and other loans covered by the program of no more than 9 percent, but within that total allow for differences between particular banks in particular regions of the country. The program will also attempt to restrain the growth of speculative loans and loans for takeovers, while maintaining as much as possible availability to small business, farmers, and others without access to alternative forms of financing which larger business firms didn't have.

Large domestic banks will be required to report monthly, and medium-sized banks quarterly. Large corporations which are heavily in the commercial paper market will also report on their use of that market monthly.

The objective, as I said, is to restrain credit in a way which helps direct it as much as possible to productive uses without at the same time saddling the economy with a straitjacket of new bureaucratic controls.

And the third element of the credit restraint is an increase in the cost of money that banks in effect buy in the open market, thereby aiming to restrict, again, the growth of business credit to a more reasonable rate of growth. And in doing this, the Federal Reserve will use both its traditional powers and the new authorities authorized by the President.

These steps in the credit area are designed in effect to put a halt to the excessive growth of spending and credit, and thereby contribute to the dampening of both inflation and inflationary expectations.

Let me turn quickly to the wage and price standards. The President and all his advisers have reiterated again their opposition to wage and price controls. We have no authority for such controls. We do not seek such authority. We will oppose any attempts to provide it.

The President did issue the new pay standards which have been recommended by the tripartite labor-management-public member Pay Advisory Committee, providing for a range of pay limitations in the 7½- to 9½-percent range, and stating that under normal circumstances we would expect settlements to average 8½ percent. Now, you clearly can't achieve an 8½-percent average if everyone feels free to come in at the top of the range. And so we have asked all large firms with more than 1,000 employees giving wage increases greater than 8½ percent to report such increases with supporting data to the Council on Wage and Price Stability.

We will be asking for a substantial expansion, about a tripling, in the monitoring capability of the Council on Wage and Price Stability, setting up industry teams to monitor wage and price developments within COWPS. And where it makes sense, we will ask large firms for prenotification of price increases. We will investigate out of line increases in wages and prices, and report publicly.

I submit Mr. Chairman, that those standards basically did work in 1979. If you look at the rate of increase in prices outside of the housing and energy area, you will note that despite very large increases in the cost of living, those standards did tend to keep wages and price increases from accelerating significantly. We believe that they need to be reinvigorated, both in terms of bringing them up to date and in terms of a substantial expansion in our capability to monitor their application.

Energy. The single most important cause of inflation in the Unite States and abroad, not the only cause but the single most importa cause, has clearly been what has happened to oil prices. I won't reci the statistics. You know them.

As you also know, the effort is now well underway to put a ne long-term energy policy in place, and I won't again take your tim up with describing what is already either in place or what the Co gress has in front of it and clearly can be enacted very, very shortl

Over the period of the next 10 years, those measures can well c imports in half, and this economy made encouraging progress last ye in cutting its petroleum consumption. The last 4-week period in 19 had, as well as it can be calculated—this what's called produc supply—total disposition of product supply of petroleum produc some 9 percent below a year ago. So that our long-term measures a ambitious and should be in place shortly.

And in the short run we are making progress. But over the ne 5 to 7 years, Mr. Chairman, we will continue to have a very dangerou dependence upon imported oil, and therefore the President took a additional step to conserve oil and reduce imports. The United Stat still consumes gasoline at a per capita rate far in excess of any othe country, and at a price far below that charged anywhere in the worl So the President, using his powers, imposed a gasoline conservatio fee on imports, and in turn we will use the entitlement system to co centrate that fee exclusively upon gasoline at a 10-cent-a-gallon rat

On the basis of our estimates, this should yield savings in import of about 100,000 barrels a day at the end of a year and about a quarte of a million barrels a day by the end of 3 to 4 years. It will help th United States in its bargaining position in the International Energ Agency, where we have taken the lead trying to work out a commo approach to avoid a scramble for limited oil resources.

We believe this will significantly improve our bargaining abilit and significantly improve the chances of coming to some kind of a agreement with other consuming nations along these lines. That fe will produce $3 billion in revenues in 1980 and about $10 billion i 1981. Those revenues will not be used to balance the budget. That wil be achieved by spending cuts and, to a lesser extent, by the withhold ing on interest rates and dividends. But the revenues from that fee wil indeed be a margin of safety against unforeseen developments o changes in estimates. In other words, our budget balance in 1981 i based upon our best estimates of revenues and expenditures, but reve nues from the gasoline fee will insure that even if events prove ou estimates too optimistic, the budget will still be balanced.

All of these measures, Mr. Chairman, demonstrate, I believe, a firm intention to control inflation and halt the spread of double digit in flation from energy to the rest of the economy. I believe the congres sional attitude of cooperation to date has underlined the credibility o that determination. The results are not going to be immediate. The next several months will give us very bad inflation news. In the pipe line already are some substantial petroleum price increases, which wil be passed through. Mortgage interest rate increases which have already occurred will be reflected in the next several months of the CPI. So that we know for several months we will continue to get very bad in flation news.

Later in the year, however, inflation should indeed come down substantially from the rates of earlier this year, heading to single digit inflation in 1981.

The final details of our new economic forecast are still being worked on. They will be submitted to the Congress together with the line item details on the budget before the end of the month.

Broadly, however, taking all of this, a reevaluation in the way the economy is going and the program together, we expect smaller and later economic decline in 1980 than we had forecast earlier, perhaps a half percent decline in GNP fourth quarter to fourth quarter, instead of 1 percent. We would expect, conversely, somewhat slower growth in 1981 than we had forecast earlier, perhaps 2 percent rather than really 3 percent of the January forecast, maybe 2¼, but somewhere in that ballpark.

We would expect the unemployment rate by the end of 1980 to rise, but to be below somwhat the 7½ percent rate we had earlier forecast. We would expect inflation for the four quarters of 1980 to be perhaps 1 percent higher than we had originally forecast. So that for the GNP deflator, which we had forecast at a 9-percent growth, we would now expect 10. And the CPI increase we would expect in the range of 11¾ to 12 rather than the 10¾ we had forecast earlier.

But conversely, in 1981 we would expect the CPI inflation rate nearer to 9 percent.

With all of this, Mr. Chairman, with all of this, the longer term problem of inflation still remains. This program should demonstrate the credibility and the seriousness and the effectiveness of our efforts to take out what has been happening recently namely, this widening of inflation throughout the economy. But it still leaves us, even with success, with an inflation rate that is too high, with an inflation rate that is in the very high single digit numbers, and therefore we need longer term measures. For improving the efficiency, effectiveness, and productivity of our economy, which would be so essential in bringing down long-term inflation, the most important thing is price stability.

Price stability and a reduction of uncertainty about the future is the most important single thing we can do; that is why demonstrating that we're moving in the right direction and reducing that uncertainty is so important. Clearly productivity change and efficiency growth comes from doing new things, doing things differently and taking risks, and uncertainty is the enemy of risktaking. Thus, reducing that uncertainty, bringing more stable conditions, is critical.

A long-range energy policy is critical because the most important kind of gain in efficiency is better efficiency in the use of energy and better efficiency in the use of alternative sources of energy, and that is underway. Deregulation is another area that is critical. Opening up to competition large areas of our economy that have been sheltered and removing some of the idiotic restraints upon efficiency which the regulations often impose is underway. It has been done in the case of airlines. It is now before the Congress in the case of trucking, in the case of railroads, in the case of banking, in the case of communications.

And finally, more investment, Mr. Chairman. Investment is not the only answer to productivity gains by any means, but it is an important answer. We believe that the kind of budget stringency con-

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tained in the President's program lays the groundwork to free up resources for investment.

Balancing the budget is our first priority and remains our first priority. Control over this bulge of inflation is the first priority. But when it becomes clear that the authorizing and appropriations bills and the spending flows are in fact consistent with levels needed to balance the budget, then the President can and will indeed be able to propose tax reductions aimed at stimulating investment and productivity growth.

We believe this, the President and his advisers believe it, and we are with you and the committee in terms of the need for long-run measures. But, we reemphasize that our first and immediate priority is and must be balancing the budget. That must be our first objective.

Thank you, Mr. Chairman.

Senator BENTSEN. Thank you very much, Mr. Schultze. And I appreciate very much, with all of the limitations on your time and the fact that we kept you away from your office for probably 10 days, that you would take the time out to come testify before us today on such short notice. I promised you I would try to get you out within 1 hour, but I hadn't anticipated that you would talk quite so long, Mr. Schultze.

Mr. SCHULTZE. I would adjust my expectations to your experience, Mr. Chairman.

Senator BENTSEN. You do have to give us all a crack at you. And I would ask that my colleagues limit their questions to 5 minutes, if we can.

I just checked on the financial markets. They tell me the Dow Jones is down about $8.50, the bond market is quiet. The price of gold on the London markets dropped about $49, and the dollar is strong throughout the world. So the initial response appears to be favorable.

Would you comment on what the reaction has been?

Mr. SCHULTZE. Oh, I can comment. But I'm not sure how usefully. I'm not sure 1 day's events in the financial markets are significant.

Senator BENTSEN. Fine. Then let's go on to the next question. The one thing that wasn't put in there that I felt strongly about in a more definitive way, of course, was something on regulations and on tax cuts to increase productivity. This committee has been a leader in that point of view.

Why aren't we doing more in trying to get cost effectiveness on regulation? That is a relatively simple matter, but very far-reaching and a major impact. The administration has supported it, but I don't see the push behind it that I would like to see.

Mr. SCHULTZE. Mr. Chairman, we submitted a regulatory reform bill last session—and I solicit your assistance and the assistance of the committee to push it—which would require, as you know, that regulatory agencies either choose the most cost-effective alternative of each regulation or, if not, explain why not. There are some cases where there are reasons for choosing another alternative.

The bill makes this a formal part of the law, applying across the board to all major regulations. I bet that the Council of Economic Advisers now spends 20 to 30 percent of its time on precisely trying to get cost effectiveness in major regulations issued by the Government.

The bill is in markup in the House, as I understand it. It is in committee in the Senate. I urge all the support you can give us in trying to get it through. It is an important bill.

Senator BENTSEN. We heard estimates of a $16 billion deficit and we have heard—I believe the CBO number is up in the area of $24 billion deficit. And we hear of cutting expenditures by $13 billion and bringing on additional tax revenues, perhaps in the area of $3 billion by instituting withholding on dividends and interest payments.

My understanding is that the proposal is for a 15-percent withholding and no increase in taxes, just to get at those people who don't report the income. My understanding is, from the estimates that we've received, that you are talking about over $6 billion of unreported income, people in effect defrauding the Government, not paying taxes, by not reporting that income, and that that is what you anticipate picking up by that withholding. Is that correct?

Mr. SCHULTZE. Basically, that's correct. I think there are two sources of the additional revenue. First, as you indicate, taxes that simply were not paid before; and second, you're getting them in faster.

Senator BENTSEN. Well, that is a one-time thing, and that is in effect giving away their other option, saying they can't use the option on last year's return. They have to estimate on the true earnings of this year. You pick up perhaps 2 or 3 months at one time.

But in these numbers, what kind of deficit would we have without the President's program that you are now proposing?

Mr. SCHULTZE. Well, I can give you the mechanical answer. The mechanical answer is that if we reestimate the budget on the basis of what we know is happening to spending today on the basis of the economy and on the basis of higher inflation and everything else, with no new program, it would come out about awash, somewhere still in the $14 billion or $15 billion or $16 billion area. It is our judgment that that would be the case.

What we have done in the estimate I have given you of a balanced budget is taken account of all of those revisions, taken account of $13 to $14 billion in expenditure cuts, of something about $3 to $3.5 billion from the withholding on interest and dividends. When it nets all out, we come out to somewhere between a balance and $3 billion of surplus, before taking into account the revenue yield from the fee, which would be about another $10 billion. But we're not counting on that in terms of our budget balancing.

We do believe it is an important margin of safety, however. You know, things change so rapidly you can't pin down your estimates that precisely. We believe they are the best that can be made. But this does give us a margin of safety.

Senator BENTSEN. Is there any one thing you can point to as to the reason for the difference in the estimates between the administration and the CBO?

Mr. SCHULTZE. Some of the estimates are still being worked out; we are still talking at the technical level with the CBO people. It is my understanding that in 1981, the differences are not principally on the revenue side. In fact, I think their revenues may be slightly higher than ours, not lower. The differences are on the expenditure side, and on the expenditure side it comes down to different methodologies of estimating. It's a very difficult thing.

For example, what is the impact of economic conditions on how many people come into the SSI program? In many cases, I understand, about $3 billion to $4 billion is a matter literally of judgment, something that reasonable people could call it either way. When you're dealing with a $600 billion expenditure number, a difference in estimates of less than 1 percent really is not that big.

Senator BENTSEN. Mr. Chairman, I could not agree with you more about the absolute imperative of turning the psychology around on inflation expectations.

I was reading a report that personal bankruptcies in this country jumped 21 percent. That's the largest increase in personal bankruptcies since the depression. Now, hopefully what's happening on credit cards—the restraint there—will be of some help on that.

I was reading a report where some people were starting to do their Christmas shopping or had been doing it before this restraint, doing it now because they were anticipating it was going to cost more later on.

So this discipline that you are proposing on the credit cards would be one of what? A limit on the amount of money? And then on those that have installment payments, some contraction in that?

Mr. SCHULTZE. What the Federal Reserve would actually do—let me give an illustration with, let us say, a major retailer which had a revolving credit plan. As of, I believe it is March 15, for any increase in the total outstanding credit, that retailer would have to deposit a reserve with the Federal Reserve System. That makes an increase in credit expensive. On the basis of past history, it is fairly clear that those retailers will tend—and banks and whatever as well—to ration that credit by a variety of means: maybe accepting no new cardholders, perhaps increasing the minimum repayment ratio, perhaps increasing the screening in terms of the eligibility for new cards.

What we have done is not write a whole batch of regulations to tell people how to limit credit growth, but rather, at the margin make credit growth expensive and therefore let them decide how to ration it the best way. There are different conditions in different parts of the country and with different kinds of credit givers.

Senator BENTSEN. My time has expired. Mr. Vice Chairman, Congressman Bolling.

Representative BOLLING. Mr. Schultze, the question I want to ask you—and I have to give a little prelude to it—you and I, I think, were at virtually all of those 10-day meetings which went over a full weekend among Democrats from the House and Senate and the administration. I guess the Secretary of the Treasury was the leader of the delegation from the Executive, and he was there all the time.

My impression that the key element in all of those conversations—and they were among Democrats—was a fundamental commitment to the Nation of compromise, that all of us had our pet projects, our pet programs, our pet views; and that we reconciled there were enormous differences in that room, regardless of the changes in the number of people and who the people were; and that somehow or another—as a beginning, as a help to the President—we had to see if we could come up with any program that we could compromise on.

Now, I don't feel like a martyr, because I watched everybody else do it. But the two programs that I care most about are gone. They are

new programs and they are gone for the year 1981. And everybody did something like that, just within the Democrats.

Now the President comes up with his approach, which is not precisely what ours would have been, but it certainly took advantage of the information that had been developed. And already you can see the process going on in this country that has been going on on every major economic policy for years: Everybody is backing off into their own special interest.

I was in my district over the weekend and every interest group that could get to me was saying, we are for doing something about inflation, but not mine. Now, that's the way we started out in that meeting, and that's not the way we ended up. And I don't believe that there should be any quelling of the debate or the discussion or the disagreement, but it seems to me terribly important that people understand that unless at some point we attempt to come together on a program that goes beyond the interests of any one of us, we will never stem inflation.

It will be sort of like the old days on civil rights, where the pro-civil rights Democrats and the pro-civil rights Republicans always outbid each other on what should be done, and nothing was ever done. Until some kind of intelligent compromise could be worked out, there was no civil rights legislation. The same thing was true of every major step forward that I've seen this country take. It has come from a compromise eliciting a majority.

Now, the next step in this process is for the Congress to support enough budget cuts to come up with a balanced budget in 1981. And not a soul is going to be content with that. No one is going to get exactly what he wants. And it seems to me the terribly important thing is that we are dealing with psychology, and that unless we achieve compromise across ideologic lines, across party lines, across the lines between a liberal and a conservative, that we will not have a policy that can be effective.

We can destroy this endeavor in the first 5 days, and I don't think it is insignificant that most of the caviling with the President's program has come from within the country and most of the support has come from without, where people may have a slightly less self-interested view and a slightly more objective view.

There is no attempt in this or in asking you this question to quell debate or disagreement. It should exist. It should continue. It should be loud. But the decisions are going to have to be compromise decisions or we will have no anti-inflation program.

Now, where do you disagree with that approach?

Mr. SCHULTZE. If I had a magnifying glass. I could not find a disagreement, Congressman Bolling. It was so eloquent, there is little I could add to it. Maybe two very small things.

In a democracy there's no such thing as discipline. There is only self-discipline. And with the large number of perfectly legitimate differences—urban, rural, you name it—self-discipline really means compromise. There is no way I could agree with you more.

Let me also note that, rightly or wrongly, the response to this program from world leaders so far has been not only unanimously good but unanimously enthusiastic and unanimously, I think, appreciative

of America's intent to exercise self-discipline in budget, credit, and energy. Beyond that I can't add to what you had to say.

Representative BOLLING. I will only add to what you said that the reason that these free world politicians—and that is mostly what we're talking about—understand what is going on is that they are the leaders of free societies and they know that they have to achieve their policies through compromises, and they read between the lines and don't pick between the lines. Thank you.

Thank you, Mr. Chairman.

Senator BENTSON. Thank you very much.

Congressman Brown.

Representative BROWN. Mr. Chairman, thank you very much.

Mr. Schultze, let me say to you, as I have said before, I am a Charlie Schultze fan, and this is the Charlie Schultze I see in front of me, not the other one, although I like him, too. And I think that the program that has been outlined is, as Congressman Bolling said, an important contribution to try and stem what may be in fact developing some real concern or panic in this country about the economic situation.

But I am not satisfied with what the President has chosen to do, because I consider myself, as I consider you, a pragmatic economist; that is, one who says that the circumstances change and as they change we must change the method by which we address them in the sense of economics. It is for that reason that I feel that it is now too late for a general tax cut, on the assumption that we will put funds into savings automatically, because I think the situation we find ourselves in currently is that people are dipping into their savings, perhaps even into their other investments like gold, to cash them in further in order to be able to meet the needs that they have for operation, either as businesses or as individuals.

The thing I find true in my area is that the banks and savings and loans are shutting down rather tightly on credit availability in certain markets, and we may be moving quite rapidly into a much more serious or much less optimistic situation with reference to the economy and its activity and employment. So I am concerned about this thing moving so rapidly that we may be quickly into a more depressing situation, if I can use that euphemism, in terms of the economy as a whole.

It seems to me that what we needed was consumer spending restraint, and to some extent your program offers that, and expansion and modernization of U.S. production, and I don't see much of that in the program that the President has offered. And so, like the chairman, I'm a little disappointed in that regard.

You mentioned risk and uncertainty in your comments, and I must say to you that risk and uncertainty are only one brake on investment. If you balance the budget with tax rates that choke off savings and investment, you will have no savings and investment, and you can be sure of that. That is the certainty that you will have. And I would have to say to you that I don't have a great deal of faith that the tax increases that were imposed on energy are really in fact going to do much more than restrain consumption of energy. Rather, I would think they would have a much more severe impact on restraining the production of energy in this country, because it seems to me that the way you focused it, that that will be the result.

Now I will pause and let you respond to that, if you want to do it. But I am anxious to know if there is anything in the program that expands the production of the society, to balance out what is going to be a rather sharp consumer spending restraint in the program, as I understand it.

Mr. SCHULTZE. Let me first note that I have to disagree, with all respect, that the gasoline conservation fee is somehow going to reduce energy production in this conservation country. I don't quite understand that. It seems to me that what we have is a situation in which the prices we charge for gasoline are far below those charged almost anywhere else.

It seems to me that while a very large increase would not have made sense, this kind of an increase which the President is now asking the Congress to turn over into a regular, longer term ad valorem tax makes all kinds of sense. It's not going to make or break the country with respect to energy, but it is that one additional step. And we have already found, in terms of our credibility now with our partners abroad, that this—and it's not a little 10 cents; it's $10 billion worth of 10 cents'—is really making a big difference. Quite frankly, they are saying that, (a) in a period in which prices have already gone up a lot, and, (b) being an election year, America is making a real effort to do this, and it's really going to help us.

Representative BROWN. Well, let me explain to you what I think will happen in the energy situation. The entitlements program still is in existence, and so the fee on foreign oil will in effect go into that entitlements program, so that firms which have access to domestic oil and gasoline will have to pay importing firms to ease the competitive disadvantage that importers have.

Mr. SCHULTZE. No, sir.

Representative BROWN. That's not correct?

Mr. SCHULTZE. It's not like the regular entitlement, which is imported versus domestic. This is gasoline production. It has nothing to do with where you get your oil, import, domestic, or whatever else. Gasoline producers pay into, in effect, a fund.

Representative BROWN. But we now are importing some gasoline.

Mr. SCHULTZE. But that is a very small amount. We do, but it is a very small amount—gasoline product imports.

Representative BROWN. But for every barrel of crude imported, gasoline amounts to about 42 percent of the barrel in terms of what it is converted to.

Mr. SCHULTZE. Normally, refineries are different, but yes, that's right. But that has little to do with it. What this says, in effect, is that each producer of gasoline in the United States pays an "entitlement," equal to 10 cents a gallon, which in turn is precisely enough to reimburse every importer of crude oil for the fee.

Representative BROWN. Well, it still seems to me that that will work as a deterrent against domestic production. If you wanted to raise the price, why didn't you decontrol the price ahead of the 1981 schedule, so that in fact that 10 or 15 cents that that impact would have had would have raised the price and discouraged the consumption. And you wouldn't have to worry about the fees at all.

Mr. SCHULTZE. We considered that. But one key reason, I think, is that, unlike a gasoline fee, which you can see sharp and clean and rela-

tively neatly, instant decontrol would have put a major cost push through all segments of the economy. You couldn't even see it. It would impact plastics and chemicals.

This way we think we can isolate the second-round inflation effects, because the fee out there is obvious. In the other case, you couldn't. It is much more difficult to do. So that was our reason for going the route we did.

Representative BROWN. Well, my time is up, Mr. Chairman. Thank you.

Senator BENTSEN. Congressman Reuss.

Representative REUSS. Thank you, Mr. Chairman.

Thank you, Mr. Schultze, for your generosity in giving us this time.

I am very pleased by the sorting out of elements in the President's anti-inflation program. You mentioned the big five. They happen to be exactly what has been in my own mind as the necessary framework. As a matter of fact, in order to make this more understandable to the average citizen, I have commissioned a muralist to paint a great painting, which will be unveiled in the House Banking Committee room the day after tomorrow, which shows as our bulwark against inflation the major fortress, your long-term point, structural reform, and then surrounding it are four outworks: a balanced budget, austere control over the money aggregates, wage-price actions, and greater energy conservation—just what you've got.

So would you think that this little exercise in imagery would depict what is in your mind as well as in my mind?

Mr. SCHULTZE. At the risk of being accused of having a medieval mind, yes, sir. [Laughter.]

Representative REUSS. I have, however, some difficulties, having set up this structure, I have difficulties with some of the armament the administration has put in them. Some elements of the structure I find pretty much pigeonholes without any real substance in them. Let me talk about some of these.

For instance, under long-term structural change, which you and I both regard as central, the White House calls for Congress to lift the ceilings that limit the return most small savers can earn. I couldn't agree with you more. We are doing it. We hope to have good news for you and the world in a few days.

But why is it, having told the small saver that he is now free on a phased basis, of regulation Q, and can get out and earn what the market pays, that you are now zapping him and telling him that, on his way to the money market fund, he can't buy it except at a mandated penalty? Why did you do that?

Mr. SCHULTZE. Well, I think the major reason—this is very importantly a matter of the Federal Reserve and the orderliness of the credit markets. But very importantly, because of the impact on thrifts right now. The difference between passbook rates at 5¾ and money market rates is really a huge difference.

What we're talking about here is a much smaller difference. But it is very importantly a situation in which you need some protection at the moment in these very high short-term rates against money flowing out of the thrifts. This is one of those protections.

Representative REUSS. Of course, that was precisely the argument

which we all listened to when we mistakenly enacted regulation Q: We have got to protect the thrifts. But we so festooned these distortions on the market that it became a disaster.

Furthermore, you might ask your legal counsel whether the administration really can do that under the Credit Control Act of 1969. I know something about the act, because I wrote it, and it says, when the President determines that such action is necessary or appropriate for the purpose of preventing or controlling inflation generated by the extension of credit in an excessive volume, he can then go ahead and act.

Well, I don't see why it generates credit in excessive volume if Uncle Fred takes his account out of a bank and puts it into a money market fund. In either case, an intermediary is intermediating.

Mr. SCHULTZE. But conversely, Congressman Reuss, under another hat, it obviously is very important in terms of what you're able to do with respect to business credit and the limits that are thereby placed upon you in terms of what you know that might do to the thrifts. And therefore, if one looks to the much larger picture of how one controls credit, this is an element making it possible to do and thereby reduce inflation, without at the same time endangering more than has to be endangered the financial soundness and condition of the thrift institutions.

So in a broader context, it is quite relevant, even though in terms of any specific act of taking funds out of a thrift and putting it in the money market funds you are quite right. But in the broader context it is relevant.

Representative REUSS. Let me turn to another aspect of the credit program. There is listed in the voluntary credit control program some goods and some bads. The bads are, I think, valid bads: speculative lending, corporate takeovers. The goods are good goods: housing, small business, and so on.

But I'm surprised at this. I would have thought that the greatest good of all was loans for productive capital investment. But I don't find it. Maybe shouldn't you take a second look at that and put that among the chosen?

Mr. SCHULTZE. Well, I don't quite know how to respond. In the first place, somehow I remember the term "productive"——

Representative REUSS. I've searched the Fed's documents, and if I'm wrong the record will so state, but I don't find it in there. And shouldn't it be? That's the best way of fighting inflation, to encourage new plant and equipment.

Mr. SCHULTZE. Most importantly, I would suggest that in all probability and in all propriety, this kind of detail is something that Chairman Volcker and you should discuss. I don't want to be in a position one way or the other of fundamentally usurping his program.

If, however, it doesn't explicitly address productive credit it does so implicitly.

Representative REUSS. Well, fine. I will. But I would point out to you that under the Credit Control Act, it is the President who acts. The Fed can tell him to jump in the lake, if it wants. They haven't in this case. They have, to their credit, gone right along. So, I would hope that both you and the Fed will take a look at this. And if there is a chink in the armor, plug it.

I will have a few more questions, but my time has elapsed.

Senator BENTSEN. Senator Sarbanes, you have been waiting quite a while, patiently, now.

Senator SARBANES. Well, thank you, Mr. Chairman.

Mr. Schultze, I am concerned. I think you have got to keep moving. You put the package out on Friday, and I think you should have had another set of meetings this morning to underline the point that you are going to carry out steps 1, 2, 3, and 4 and keep going, so that there is a sense not only that the administration has focused on this problem but that it is remaining focused on it and it is staying on it.

For instance, when is the President's revised budget for fiscal 1981, which will be in balance, going to be submitted to the Congress?

Mr. SCHULTZE. All I can tell you at this stage, Senator, is that Mr. McIntyre, who really is the one in charge of putting this all together now, is taking the list that has now been developed and getting Presidential decisions on the line items, putting it all together, getting it all up here. A large part of this is almost mechanical, but he tells me it will be more clear by the end of the month. Now, the specific date I do not know. I am not sure. He may not have a specific date. But by the end of the month it will be up in all its glory.

Senator SARBANES. All right. That is an essential precondition of the Congress' going to work on the budget and being able, in effect, to respond appropriately.

Has the administration considered asking the Congress to complete the budget process, if possible, in a somewhat shorter period of time than would ordinarily be the case?

Mr. SCHULTZE. Not that I know of, Senator. I have no comment one way or the other on that. I just haven't thought about it.

Senator SARBANES. What is going to happen with the State conservation targets for energy conservation, which you hope to do voluntarily with the Governors? When do you meet with the Governors, and when do you implement the voluntary plan on energy conservation?

Mr. SCHULTZE. On the specific timetable for meeting with the Governors, I am sorry to say I will have to give you an answer for the record. I will get it from DOE and will give it to you. I don't have the timetable on that.

[The following information was subsequently supplied for the record:]

TIMETABLE FOR STATE VOLUNTARY GASOLINE CONSERVATION GOALS

In December 1979 the Department of Energy transmitted to the States the initial State gasoline consumption goals for the first quarter of 1980.

During the week of March 17 the Department of Energy transmitted to the States the goals for the second quarter of 1980. These goals were accompanied by an offer of assistance to each State in development of a conservation plan to achieve the State's target.

Senator SARBANES. On the withholding of interest and dividends, I strongly share the chairman's statement at the outset with respect to this particular issue. I understand that while only about 2 or 3 percent of wages and salaries, where there is withholding, go unreported, the comparable figure for interest and dividends is somewhere between

10 and 15—roughly, 10 and 15—percent. When will the President propose legislation?

Mr. SCHULTZE. As soon as Treasury can get the technical work done, which should be very quickly. But, again, I don't have a given date. But Treasury is now working it up.

Senator SARBANES. The only point I am trying to make is that the proposal having been made, with the proposition now out on the table, this Treasury task force ought to be working around the clock to send the proposal to the Congress.

Mr. SCHULTZE. It is. It is working very hard on this. All of these items are being followed up. It is just I don't have a timetable of dates with me.

Senator SARBANES. Now, prices and wages. I would have been encouraged if the Secretary of Commerce and the Secretary of Labor had this morning launched a series of meetings—joint, perhaps—with the leaders of business and labor to consider how they can work at moderating wages and prices in the months ahead.

What's going to happen in this area, other than this giving some more staff to COWPS? That's not the kind of high-level involvement that I think is necessary. If you are going to make a voluntary program work. You will need your Cabinet Secretaries and, in fact, the President himself.

Mr. SCHULTZE. Well, it does. And in effect, their involvement will be forthcoming. But at the same time, what is also needed I think—and this is what we want to do—is not so much a conglomerate sort of approach, but an industry by industry one where you can talk about specifics.

Senator SARBANES. Well, that's all right. Let's get at least one or two industries out there on the table and start working on them.

Mr. SCHULTZE. Right. That's what we want to do.

Senator SARBANES. If you don't do that, all that will be left for people to focus on is the first proposal you presented there, and harass that to death.

Mr. SCHULTZE. Well, in the first place, you know, it was my understanding that COWPS is trying to set up its first industry meeting this week. Now, I haven't had a chance—that's one of the problems——

Senator SARBANES. Don't you think you ought to raise it to the level of the Cabinet—to the level of the Secretaries of Labor and Commerce and, indeed, the President himself?

Mr. SCHULTZE. We may very well do that. I would not want to rate Fred Kahn significantly below a Cabinet member. But at any rate, I see your point.

Senator SARBANES. On credit policy, it seems to me that you need to get an important distinction into place as quickly as possible and have it understood in the country. It is the distinction between the excessive use of credit, which is exemplified by credit card abuse, and the essential need for credit on the part of productive enterprises, small businesses, farmers, homebuilding industry, who make a contribution to the economy, have made it in the past, and we hope will continue to make it in the future. You need to make clear that that distinction is not only recognized but is being implemented, so that there is a sense in the Nation that this approach is going to have a balance in it that will enable it to work.

Mr. SCHULTZE. Well, the Federal Reserve has already put out, as of Saturday, a fairly specific eight-page document spelling out the program precisely along those lines. It is already underway.

Senator SARBANES. Well, I know they have done that, but it is not being translated very well to the public in terms of reassurance, on the one hand, which I think is essential, and the discouragement to potential speculation on the other.

And finally, in order to enhance the sense of a policy that knows where it's going and that its implementation requires, the administration ought to focus on various specifics that can be done. Congressman Reuss referred to the financial institutions legislation now as in position to pass the Congress; the windfall profit tax will be here in the Senate this week. We've got the other two major energy bills.

It would seem to me that the Department of Energy ought to put together a list of priority targets that they are addressing in an urgent way. The Alaskan natural gas pipeline would be one that I would just throw out for consideration.

It seems to me that having come this far in proposing a program, you have to maintain a sense of intensity and urgency in implementing various aspects of it. A lot of that involves the timetables on which you are proceeding—putting forward the program and calling on the Congress to make the decisions we have to make, and obtaining Executive and administrative actions.

Mr. SCHULTZE. If you go through it item by item, we have a plan. I just don't have a specific final date to get the new budget up here in all its glory. The Council on Wage and Price Stability is developing a plan to go meet with industry leaders and labor leaders on an industry-by-industry basis, and we are starting this week.

The President, his congressional liaison staff, and the relevant departments have been engaged in areas where it is very important for them to get some legislation out of the Congress. Trucking deregulation is a case in point. The windfall profit tax, the Energy Security Corporation, the Energy Mobilization Board, are all examples of that.

I agree with you fully. What I don't have is kind of a pert chart with all of the dates on it. But I fully agree with you that on all of these things we have got to follow up. We are, and undoubtedly we have got to do more. We are proceeding to do that.

Senator SARBANES. I think the same kind of intensity that marked both the administration's concern about what is happening to the economy and its response—and I am not going to argue now whether or not it is enough—now has to mark your followup steps. Otherwise, the movement in dealing with this matter, which I think is essential, is going to be lost.

Mr. SCHULTZE. Thank you, Senator.

Senator BENTSEN. Congressman Rousselot.

Representative ROUSSELOT. Thank you, Mr. Chairman. Mr. Schultze, it's nice to see you here so soon after presenting the last budget. It must have been a real task to reverse gears and come up with a new budget so soon after presenting a so-called solid budget in January.

Mr. Schultze, I also want to say that there are not many of us on this committee who necessarily think that a balanced budget comes from a medieval mind.

Mr. SCHULTZE. It was not a balanced budget. It was just the analogy.

Representative ROUSSELOT. Well, you did say it was a medieval mind trick.

In any regard, since Congressman Bolling prefaced his questions with a speech, let me preface mine with a few quick comments. Congressman Stockman, Congressman Gramm, and myself presented a laundry list of specific expenditure cuts to the House Budget Committee last week: 26 billion dollars' worth. We will send you a copy.

Mr. SCHULTZE. I have it.

Representative ROUSSELOT. Good. I am glad. Our mail system works.

Frankly, I had a longer list that totaled $35 billion. I bring it up today because there are a lot of us here in the House and the Senate that believe we can do a lot better than $13 billion in expenditure cuts. Many of the President's cuts are just reductions in increases, as you well know, for 1981.

Therefore, we disagree with your theme, as does this committee as a whole, in its annual report. Have you had a chance to review that report very carefully?

Mr. SCHULTZE. Yes.

Representative ROUSSELOT. As you know, we called both for tax cuts and expenditure cuts. We disagree that "we have to forego tax reductions," which I believe was your quote. Wasn't that your quote at the press conference the other day?

Mr. SCHULTZE. For the time being.

Representative ROUSSELOT. Are Mr. McIntyre and the others responsible for sending this program up going to totally rule out any tax cuts?

Mr. SCHULTZE. We have already ruled them out. As of now, we have already ruled them out. By we I mean the President of the United States and all his economic advisers. It is not Mr. McIntyre or Mr. Schultze or Mr. Miller. It is all of us. And the President made a decision. Our first priority is to balance the budget. We believe that is necessary.

Representative ROUSSELOT. We understand that. However, many of us believe that we can do both.

Mr. SCHULTZE. I understand that.

Representative ROUSSELOT. Let me suggest to you that you look at discussions held in the House during consideration of various past budget resolutions. During these discussions, many of us have brought on ways that you can achieve all three things: A balanced budget, a reduction in taxes, and a reduction in expenditures. Pursuing this course would prove far more effective in stimulating growth and reducing unemployment.

As you know, the President's original budget proposal called for 7.5 percent unemployment. In contrast, the Kennedy tax cuts of 1963 and 1964, which went to both corporations and individuals, increased employment and stimulated growth. Furthermore, the inflation rate, except when we got into the war later on, was nowhere near as great.

All this goes to show that tax cuts and expenditure cuts can lead to greater employment and increased economic activity. More importantly it can lead to improved investment opportunities which we

urgently need, as you have said many times, for jobs and new plants so that we can compete.

Now, how can we persuade you to give consideration to tax cuts which this committee has called for?

Mr. SCHULTZE. We have considered it very, very hard and very, very thoroughly, Congressman Rousselot. We just disagree.

Obviously, the sheer simple arithmetic of it is, if somebody comes to me and says, "I can cut the budget by $40 billion," and, somebody else says, "I can cut it by $20 billion," and somebody else says, "I can cut it by $16 billion," you can pick a size so you squeeze in a tax cut. It is obviously our judgment, on the basis of public policy, that what the President has proposed, is about right.

Now, that doesn't mean the Congress can't and shouldn't review it. It may want to increase the cuts, for example. It is a matter of judgment as to what is possible, practical, prudent, and good public policy at this time, and how fast can you go, how far.

Representative ROUSSELOT. Well, using the criteria you just mentioned—practical, possible, and all the rest—we did it in 1963 and 1964. We have done it at other given times.

Mr. SCHULTZE. We did what?

Representative ROUSSELOT. We had tax cuts that did produce a better economic condition. Furthermore, they were not inflationary.

Mr. SCHULTZE. Under those economic circumstances, that is quite right.

Representative ROUSSELOT. But the circumstances, the inflationary impact, certainly, is different now.

Mr. SCHULTZE. The circumstances are quite different.

Representative ROUSSELOT. The inflationary impact is quite different, I agree with you. But we proved in California, with proposition 13, that tax cuts do not necessarily mean higher inflation.

Mr. SCHULTZE. You are quite right.

Representative ROUSSELOT. And there is no doubt, as the President himself has admitted, that his new anti-inflation proposal of a new tax on imported oil is, in fact, inflationary. It isn't anti-inflationary. He says it "won't last very long," but it is inflationary. Why can't we have——

Mr. SCHULTZE. Like decontrol of oil. That's right.

Representative ROUSSELOT. All right. Fine. Decontrol. We agree with that. And if you want to go ahead and decontrol the rest and let the marketplace make the decision, instead of Government or DOE, I would be very much in favor of that.

Mr. SCHULTZE. Wouldn't that be inflationary, too, Congressman Rousselot?

Representative ROUSSELOT. There is nothing quite as inflationary as more Federal taxes. I am sure you recognize that, as a sound economist.

Mr. SCHULTZE. I would not—I would not agree to any simple statement like that.

Representative ROUSSELOT. What do you mean, "simple statement"?

Mr. SCHULTZE. There are all sorts of things, some kinds of Government taxes——

Representative ROUSSELOT. Do you agree that new taxes are, in fact, inflationary, or not?

Mr. SCHULTZE. Some are, and some aren't. It depends upon the circumstances.

Representative ROUSSELOT. Well, the President said the other night, and again at the press conference, that the new tax that he is going to impose on imports is inflationary.

Mr. SCHULTZE. Of course it is. I agree with that. That does not mean that I believe that all taxes at all times are inflationary.

Representative ROUSSELOT. But that one is.

Mr. SCHULTZE. Nor does it mean that tax reductions, which sometimes can add to inflation at other times do not—it's a matter of the time, and the circumstances.

Representative ROUSSELOT. Well, as an economist, you can learn by history. The history of tax reductions in this country shows that it has not been inflationary. It has promoted growth. It has encouraged new investment in plant and equipment, which, in turn, means more jobs.

Mr. SCHULTZE. I agree it can.

Representative ROUSSELOT. Well, let's do it.

Mr. SCHULTZE. Right now, the first priority is to balance the budget, Congressman Rousselot.

Representative ROUSSELOT. But, as you know, balancing the budget alone does not do the job.

Mr. SCHULTZE. I understand that. And, therefore, we have a long-term program. We have all sorts of other things.

Representative ROUSSELOT. When are you going to reduce taxes?

Mr. SCHULTZE. We don't disagree on fundamentals. We just disagree on timing. We are going to reduce taxes when we can do so and still maintain the kind of budget discipline we need to maintain. That's when we're going to do it.

Representative ROUSSELOT. Like when?

Mr. SCHULTZE. When we have in hand at least the kind of spending cuts we're talking about. Not before. When we have in hand congressional action on those matters.

Representative ROUSSELOT. When inflation has gone up some more.

Mr. SCHULTZE. In fact, we believe very strongly that if the Congress acts along the lines the President has requested in terms of this kind of budget discipline, that will not happen.

Representative ROUSSELOT. Now, are you going to do anything about reducing expenditures in fiscal year 1980?

Mr. SCHULTZE. We are submitting any number of rescissions in the 1980 budget.

Representative ROUSSELOT. Excellent. How much will that be? That is good news, by the way.

Mr. SCHULTZE. It will reduce spending by perhaps $2 billion.

Representative ROUSSELOT. For 1980?

Mr. SCHULTZE. For 1980. Those rescissions will reduce spending in 1981 by more because, of course, as you know, there is a lag between budget authority and outlays.

Representative ROUSSELOT. I know that. But $2 billion worth of expenditure cuts for 1980?

Mr. SCHULTZE. That's correct. In that neighborhood.

Representative ROUSSELOT. I am glad to hear that.

My time has expired. Thank you.

Representative REUSS [presiding]. Back to the Federal Reserve, Mr. Schultze. The Fed would, under the new program, discourage, but just on a voluntary basis, loans for commodity speculation and loans for corporate takeovers. We agreed before that those are bad, and should be discouraged.

What I wonder about, however, is that when they came to consumer credit, specifically credit cards, then they didn't rely just on voluntary suasion; they put on a very tough 15-percent penalty.

So, my question is: You and I agree perfectly on what is bad and inflationary about speculative loans and takeover loans; but what is so inflationary about credit card credit? That goes mainly to meals in restaurants and motel rooms.

Mr. SCHULTZE. And appliances and furniture. People use credit cards now for everything.

Representative REUSS. Tell me where in that area there is a real inflationary situation of too much money chasing too few goods. As I see it, there are plenty of ghetto kids delighted to get a job washing dishes in a restaurant; there are plenty of Latin American ladies eager to be a chambermaid in a hotel or motel; there are plenty of needle trades—women and men anxious to turn out more apparel.

So, when I am not faulting you for frowning on these modest types of consumer credit, it seems to me that you should have visited your most ferocious frown on commodity speculation and corporate takeovers on which you have really done nothing except say, "Please don't do it any more." But you can be sure the financial institutions, if they have the opportunity to get a higher rate of return on those, will be impelled by their own economic determinants to do that.

Mr. SCHULTZE. Well, in the first place, let me start by simply reminding you—I know you are aware of this—that it isn't simply consumer credit against which the Fed has levied a marginal reserve requirement. It imposed that requirement against all kinds of managed liabilities last October and toughened it up this time. So, what it really did was bring consumer credit as a special item to the same general kind of treatment.

Representative REUSS. But, if I may interrupt, we are dealing with a finite supply of money and credit, and I think you and I and the Fed agree that that must be a pretty austerely growing supply. The question is, What do we do with what we've got? And there, I suggest that you are being inordinately tough on restaurants and motels and so on——

Mr. SCHULTZE. I don't know what the proportion——

Representative REUSS [continuing]. And not tough enough on the speculators.

Mr. SCHULTZE. I have no idea at the moment what proportion of consumer revolving credit is restaurants and motels. What I do know is that we didn't want to hit autos and housing; they are already weak. And on the other hand, consumer spending outside of those areas of housing and autos was moving ahead rapidly, pushing the savings rate—partly through the use of credit—down to 3 percent. We hit something we wanted to slow down.

Representative REUSS. Of course, you exempted the area of consumer durables.

Mr. SCHULTZE. No, that isn't exactly right. What is happening is, over time, more and more purchases of durables are moving over to revolving credit and less and less are on the old fashion installment loans. And so, essentially, what we really did was hit unsecured loans.

The second thing, let me note, Congressman Reuss, that what you cannot do and I cannot do and nobody can do is to say in a regulated quantitative mandatory way that this particular commodity loan is speculative and that one isn't, that this particular takeover is and that one isn't. You don't want to forbid all takeovers; you don't want to forbid all mergers; you don't want to forbid credit for any of that. What you really want to do is discourage them in a flexible way because there is nobody at the Fed or anywhere else smart enough to draw up nice, precise regulations as you would need with mandatory regulations to do that.

Representative REUSS. I couldn't agree with you more—which led me to make my suggestion to the administration a month or more ago, and I really think that it wasn't all bad. My suggestion was: don't fool around with the bads; don't try and say that this loan or that loan is bad; you can't do it. But accentuate the positive: tell the banks that, on a voluntary basis, you would like in every quarter for them to increase the percentage of their loan portfolio dedicated to investment loans for housing and capital equipment. The former sops up inflationary purchasing power; the latter, by increasing productivity, is the best bulwark against inflation.

That would not be all that difficult. What's wrong with it?

Mr. SCHULTZE. Well, I shouldn't shake my head. Maybe it could be done. What I guess I am saying is I'm really not sure that I want to shift, at least not very much, from long-term financing to short-term financing for long-term investment. I am not sure how good that would be. I would want to think about that.

Representative REUSS. But with the present bond market and stock market, it doesn't look as if the long-term sources are so good.

Mr. SCHULTZE. Well, at the moment, that's correct.

Representative REUSS. Congressman Brown.

Representative BROWN. Thank you, Congressman Reuss. I want to continue the discussion about credit rationing, and Mr. Schultze, it seems to be that credit is being rationed right now. It is being rationed, because money flows to the highest yields. And the result is that many savings and loans in the country are in trouble because of disintermediation, that is, the fact that withdrawals are hitting them, due to the difference between the return on deposits at S. & L.'s and the returns on other investments.

The obvious impact, of course, is depressing the current housing market.

The banks are having some problem with money market funds, where high rates from investment funds are taking bank deposits and thus leaving banks with less reserves for consumer and business loans. And then the local banks must borrow back the funds from the money markets, if they can, at even higher rates than the money market funds are paying, so that the local banks, if they lend to consumers or investment loans—producers—at all, must charge higher rates than they pay for the money originally.

In other words, the money is whipped around once and jumped u
their rates on loans. First, do you agree that is occurring and occurrin
at a rather rapid rate?

Mr. SCHULTZE. To some extent, yes, and that's the reason the Fe
did what it did on money market funds. That's one of the reasons,
least, why the Fed put the marginal reserve requirement on mone
market funds.

Representative BROWN. But those money markets, I think it is we
for both of us to point out, are not guaranteed by the FDIC or th
FSLIC, so anybody who jumps into the money market with the high
est rates—is now a total personal risk; isn't that correct?

Mr. SCHULTZE. To the best of my knowledge, that's correct.

Representative BROWN. Always the highest rates usually are at pe
sonal risk.

If the banks and the savings and loans, however, get into troub
because of the circumstance—either by going ahead and making co
sumer loans and then not having the reserves to cover them or by mak
ing producer loans and not having the reserves to cover any losses o
those—then the FSLIC and the FDIC guarantees are implemente
And a lot of off-budget Federal guarantees suddenly become on-budg
spending, right?

Mr. SCHULTZE. Well, I don't remember the budgetary treatment, bu
I am sure you are right.

Representative BROWN. All right. Now, let me go back to where w
are. The White House tells us that the deficit is $15.8 billion, but th
CBO puts the deficit at a probable $31 billion, and others have est
mated it as high as $45 billion.

It there any way to understand what that deficit may be, if suc
things happen as the implementation of the FSLIC guarantees an
FDIC?

Mr. SCHULTZE. Well, if you get really major implementation o
FSLIC, we've got more problems than a large budget deficit. I woul
agree, that would be a very serious situation, and the thrifts do hav
problems. I would not expect to see that happen, but if it did, you a
quite right, Congressman Brown, we have got serious problems, and
must say I would put the increase in the deficit about fifth on my lis
of the problems that that would generate.

I want to make clear that I am not at all forecasting that will hap
pen. I believe there are some financial problems here, but nothing lik
that serious.

Representative BROWN. The CBO said the budget cuts would have
largely psychological impact on inflation. But doesn't the main benef
from balancing the budget come from getting the Government out o
the credit markets? In other words, out of borrowing, to leave what
ever credit is available to the private sector, so that the Federal Reserv
can fight inflation without destroying the private sector?

Mr. SCHULTZE. Well, again, I don't know where I want to rank that
That certainly is one. It is a combination of lower total demand on ou
economy, therefore making it harder, quite frankly, to pass on highe
wages cum energy, cum other costs in the form of prices. It is reduc
ing, somewhat, the demand in the economy. It is, as you say, reducin
the Federal Government's impact on the credit markets.

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And finally it is, in a very important way, psychological—it is a real signal that the Federal Government is serious about controlling inflation. It is all three, but I don't know how to rank them.

Representative BROWN. The withholding tax on savings and interest has an exemption for those who don't earn enough to pay taxes. Do we have any assurances that the exemption process will not lead to the usual bureaucratic nightmare which will cause more frustration for the poor and the elderly and those other people who have very limited tax or very limited income returns from corporate stockholdings, and who are not therefore required to pay the tax, but have it withheld from them?

I remember I had a grandmother who had me keep her books for awhile. And if you withhold that kind of income and then have to try to get it back from the Government——

Mr. SCHULTZE. That isn't my understanding of how it would be done, although I don't pose as the technical expert or administrative expert—I think the filing of one certificate will do it. That isn't something where you pay it in and get it back. You can file a certificate.

Representative BROWN. Clearly, it will all be withheld, and somebody like that is living on a very thin margin.

Mr. SCHULTZE. It won't. That is my understanding, that there is a procedure for that person in that situation to file a certificate with the savings and loan, saying, "I do not expect to pay any taxes. Please don't withhold." That certificate will be honored.

Now, again, that is my understanding. I don't want to pose as the administrative expert on this, but it is my understanding.

Representative BROWN. I would certainly hope so, because I don't know how a corporation, when it sends out $15, $30 in dividends to somebody, is going to know whether that person gets over the $100 and the result then would be——

Mr. SCHULTZE. My understanding is it would be like a W–4. It is self-certification. But again, I don't want to pose as an expert on all the details.

Representative BROWN. Except there are probably a lot of old people who aren't going to know how to do that, and I am concerned about that, and then I am concerned about the other thing: that if it is withheld, they lose the compounded interest that they would get from getting the quarterly dividends and being able to invest them in the bank and get some kind of return.

Mr. SCHULTZE. I understand that, but the wage earner being withheld on has the same problem.

Representative BROWN. My time has expired.

Representative REUSS. Mr. Rousselot.

Representative ROUSSELOT. Mr. Schultze, I understand you have to leave for a 3 o'clock appointment, so I'll be quick. We're a little over time here, so I will submit any other additional questions I might have in writing.

However, I would like to follow through on the $2 billion cut in expenditures that you state you will send up soon.

Mr. SCHULTZE. In that neighborhood.

Representative ROUSSELOT. In that neighborhood, give or take—what? A half a billion?—but that you plan to send up for the 1980

expenditure level. Now, would it not be easier on the economic system to begin the expenditure cuts more aggressively in 1980 by rescissions or other means instead of by a sudden fiscal jolt? We're going to have a $45 billion deficit, according to the CBO. Wouldn't it be better to begin the process now than to go into 1981 with an already accelerated expenditure level, so high it is more difficult to cope with?

Wouldn't it be better to do it right now?

Mr. SCHULTZE. Well that is actually what's going to happen. Let me remind you of several things, Congressman Rousselot. In the first place, this is $2 billion in a fiscal year which is already half over.

Representative ROUSSELOT. I understand that.

Mr. SCHULTZE. By the time these cuts actually begin to take place, you probably only will have about 4 months left.

The annual rate of cut would therefore be something like $6 or $7 billion, but you aready have been into this fairly well.

Representative ROUSSELOT. Yes, but Congress has to pass supplemental approriations for much of this 1980 stuff, in many cases, so we can get at it right now.

Mr. SCHULTZE. Some of it, but the largest part of those cuts aren't going to simply be out of the supplementals. They're going to require rescissions.

Representative ROUSSELOT. Right. Well, I will be glad to send a laundry list together with some other Members of Congress who have been on the Budget Committee as I have been, and on this committee. I am sure we can find much more than $2 billion. You know, food stamps have gone from $30 million to almost $10 billion. I am sure some of that is slush.

Now, you mentioned earlier—and by the way, we are with you on revenue sharing—a lot of us have believed from the beginning that we didn't have any revenue to share—that we were broke.

Representative BROWN. That's a minority view on that. I don't agree with you on that.

Representative ROUSSELOT. Well, the world leaders you mentioned earlier today, were just ecstatic about the President's message. Unfortunately, the Dow Jones was down 20 today, so that is just a little——

Mr. SCHULTZE. That probably shows we need some extra restraint.

Representative ROUSSELOT. Well, what I am saying is here at home is where it counts.

Mr. SCHULTZE. I agree.

Representative ROUSSELOT. Well, the world leaders are great—except like Khomeini and a few others. However, I really believe that it isn't just what world leaders think. It is to their advantage, competitively, for us to have high taxes—as this committee learned when we were overseas during the recess, in Manila, in Hong Kong, in Taipei, and Seoul. Our American businessmen, because of the taxation procedures, are just killed overseas competitively.

Mr. SCHULTZE. That's strange, because our taxes as a percentage of GNP are much lower than anywhere else in the world except Japan. So that is indeed strange.

Representative ROUSSELOT. Well, we will give you our report.

Representative REUSS. Don't be despondent about the points on the Dow Jones. That is the same average that tended to show—or at least

the market averages tended to show, that Seaboard Railroad varied exactly with United Airlines, Northwest Airlines, and other nonrailroads—so I don't think that its judgment is necessarily the final word on your program.

Mr. SCHULTZE. I console myself a little bit——

Representative ROUSSELOT. Neither are the world leaders——

Mr. SCHULTZE. I remember that vividly. I think it was in 1978, when Congress passed the capital gains reduction. The day the Senate passed it, the Dow Jones fell 21 points.

Representative BROWN. Helmut Schmidt is up 10 points. [Laughter.]

Representative REUSS. At any rate, thank you very much. We appreciate and value it, as always. As far as I'm concerned, your program goes a long way forward, but I don't believe that it is strong enough. And we will be conversing about it.

Mr. SCHULTZE. Thank you very much, Congressman Reuss.

Representative REUSS. We now stand in adjournment.

[Whereupon, at 3:50 p.m., the committee adjourned, subject to the call of the Chair.]

THE PRESIDENT'S NEW ANTI-INFLATION PROGRAM

THURSDAY, MARCH 20, 1980

CONGRESS OF THE UNITED STATES,
JOINT ECONOMIC COMMITTEE,
Washington, D.C.

The committee met, pursuant to notice, at 10:05 a.m., in room 318, Russell Senate Office Building, Hon. Lloyd Bentsen (chairman of the committee) presiding.

Present: Senators Bentsen, McGovern, McClure, and Jepsen; and Representatives Reuss, Brown, Heckler, and Rousselot.

Also present: John M. Albertine, executive director; William R. Buechner, Lloyd C. Atkinson, and Keith B. Keener, professional staff members; Betty Maddox, administrative assistant; Charles H. Bradford, minority counsel; and Stephen J. Entin, Mark R. Policinski, and Carol A. Corcoran, minority professional staff members.

OPENING STATEMENT OF SENATOR BENTSEN, CHAIRMAN

Senator BENTSEN. This hearing will come to order.

This is the second in a series of hearings that the Joint Economic Committee is holding on the economic proposals that President Carter made to Congress last Friday.

Our witness today is Hon. Paul Volcker, Chairman of the Board of Governors of the Federal Reserve.

Under the economic policies that were being followed prior to President Carter's announcement, the Federal Reserve was bearing the brunt of the fight to bring inflation under control. Much to the concern of many of us in Congress, the prime rate is now 19 percent and mortgage rates are over 16 percent in many parts of the country, if you can get the money.

Yesterday's figures on housing starts indicate that this is having a serious effect on homebuilding.

While the Federal Reserve was tightening up on credit, the administration and Congress continued to entertain notions that Government spending, Government deficits, and Government regulation could continue unchecked and that we could conduct business as usual.

It's a shame that it took an 18-percent inflation rate in January to bring the Government back to its senses. But I really think that we are beginning to move down the right track. It certainly is time to balance this budget, but I believe we are going to do it. Congress is going to have to make some hard choices in the months ahead.

I only hope that we will be able to fend off those special interests who are all for a balanced budget, except for cutting their own particular interests.

As welcome as the President's proposals are, they are still too tied to the old way of thinking—that inflation can only be controlled by demand management policies that slow homebuilding and slow business investment.

I really believe that's a short-run strategy that overlooks the price we pay in the long run.

In the long run, we ought to stimulate the expansion of our economy's productive capacity, and I urge the President to propose, or at least agree to, a tax cut that will encourage the supply side as soon as we balance this budget.

The President has given the Federal Reserve a heavy responsibility to control the expansion of credit under its powers under the Credit Control Act of 1969. That's under your control, Mr. Volcker.

Mr. VOLCKER. Yes, sir.

Senator BENTSEN. I hope that those powers will be used to bring interest rates on mortgages and business loans as soon as we can back to a more reasonable level.

And with that, I would defer to my colleague, Senator Jepsen, for any comments he might have.

OPENING STATEMENT OF SENATOR JEPSEN

Senator JEPSEN. Thank you, Mr. Chairman.

Mr. Volcker, I'm especially interested in hearing you discuss the impact of the Fed's tight credit policy as it affects different regions of the Nation and different sectors of the economy.

Although, I generally support a gradual reduction in the rate of money growth, and certainly will support any measure which will help reduce the serious inflation rate we are experiencing, I am concerned that the impact of the Fed's policies may be uneven, that farmers and rural areas in the United States are suffering disproportionately from a shortage of credit.

I am sure that you will agree that if a shortage of credit in the farm sector leads to a severe reduction in agricultural production, and it is already causing many farmers to cut back their plans for spring planting, then this will only cause food prices to skyrocket next year.

I would also like, Mr. Volcker, to discuss the conditions under which you would consider, if possible, to begin easing up on credit.

In other words, if the Congress were to approve, say, $20 billion in spending cuts for fiscal years 1980 and 1981, would he then be willing to ease up a bit?

Last, I would like, Mr. Volcker, to discuss measures which the administration will support to increase the supply of goods and services to fight inflation.

As you well know, there are two sides to the inflation equation—supply and demand. And up until now, we have concentrated all of our efforts on reducing demand, or at least the Fed has concentrated its efforts on reducing demand.

I'm not sure the administration has done its share, but relatively nothing has been done on the supply side. The administration opposes a tax cut, even when studies by this committee have shown that tax cut measures to increase savings and investment will reduce inflation by increasing productivity.

And it has done nothing to curtail the regulatory burden which is increasing business costs and reducing productivity, as studies by Edward Denison and others have shown.

We are in the midst of a serious economic crisis and I am going to help everywhere that I can. I am sure in the coming weeks I am going to be forced, along with other colleagues, to vote for cuts in many worthwhile programs.

I will do it if I'm convinced it will be part of an overall program to fight inflation.

I just want to make sure that what we do here in Congress is not going to be undone by the administration or because the anti-inflation program is exacting an excessively heavy toll from farmers or any other specific group.

We are all in this together, and as much as possible, the burden should be shared by all.

Thank you, Mr. Chairman.

Senator BENTSEN. Congressman Brown.

OPENING STATEMENT OF REPRESENTATIVE BROWN

Representative BROWN. Mr. Volcker, unfortunately, many people feel that the Federal Reserve is the only vehicle available to fight against inflation. You told the Banking and Currency Committee, and I quote, "The less fiscal restraint you get, the more the burden falls back on us"; that is, the Fed.

You suggested that Congress should go further than the President in cutting the budget, saying, and I quote again, "the more that can be done in that area, the better."

Well, I agree with you. I think spending restraint is essential, but I am disturbed by the way in which you talk about monetary restraint or fiscal restraint, as if one were a substitute for the other.

The main purpose in controlling Federal spending and borrowing is to make it possible for the Fed to continue its monetary restraint, not to let it back off.

Spending restraint is not a substitute for monetary restraint, in my view. It's a complement that makes the monetary restraint bearable.

Any given amount of slowdown in money creation does less damage to housing, investment, growth, and employment if the Government cuts its spending, balances its budget, ends its added borrowing so that the Government can get out of the credit markets and leave whatever limited money there is to the private sector.

That's what makes it possible to reduce inflation without killing off the expansion and modernization of the private sector or driving interest rates sky high and risking real trouble in the banking system.

If we don't have fiscal restraint with your monetary restraint, the Fed will have to cave in to political and economic pressures to reverse its policies and give up on inflation.

You have threatened to tighten credit even further if Congress does not cut spending. I think you may be bluffing.

Without spending cuts, the Government will absorb huge chunks of the Nation's savings and credit. Savings and loans are already drained of funds; banks may soon be threatened. Many are already losing

money. They will have to turn to the Fed to convert their assets into cash.

And I think you will have to lend to them. You will have to because to do otherwise would be to repeat the Fed's blunders of the 1929, 1930, 1931 era, when it brutally failed to perform its statutory function of lender of last resort. Then where is your credit restraint? You will be injecting funds into the banking system at record rates to fund the Federal deficit to save the banking system from collapse.

Fiscal policy, therefore, can and must support your policy or it can destroy your policy. But it cannot replace your policy, and I would like to hear some comments on that subject. Thank you.

Senator BENTSEN. Mr. Volcker, we are delighted to have you here this morning. If you would proceed with your testimony.

STATEMENT OF HON. PAUL A. VOLCKER, CHAIRMAN, BOARD OF GOVERNORS, THE FEDERAL RESERVE SYSTEM

Mr. VOLCKER. I have no prepared statement, Mr. Chairman. I will just make a few very general comments, and then we can get into some of the interesting questions that have already been raised.

Let me just say, in general terms, that I don't need to emphasize that we are at a critical juncture in our economic policy to fight inflation; you have already made that point. And it seems to me equally clear that a coordinated approach involving not just monetary and credit policy, but budgetary policy, energy policy, and—looking ahead—supply-side policy, as you suggested, are very important.

I do think the budgetary efforts are critical to a balanced approach. It's critical not only to make cuts in the budget, as stated—and let me emphasize that it's not going to be an easy job—but also to make cuts to keep the budgetary trends within the projected pattern. There is no point in making some cuts, in specific programs, important as these are, if we let the trend of expenditures exceed projections.

It is going to take a continuing, intense effort to keep the budget picture at the magnitude that the President has projected. And, of course, as I have said before, anything the Congress or the administration can do to reduce it still further will be helpful.

So far as monetary and credit policies are concerned, let me make clear that it is our continuing intention at the core of our policy to pull back on money and credit growth. That is fundamental to dealing with the inflationary problem, whatever happens on the budgetary front. In that sense, policy is bound to remain one of restriction and restraint.

What we have tried to do, with the particular measures announced on Friday, is to introduce some supplementary restraints in certain directions that will help even off the impacts, because there's no question we do get uneven impacts on particular industries or particular sectors of the economy in the present situation.

I don't want to suggest that we can do the impossible of easing credit in some areas while restricting it in others. But I think we can do some things to even off the impact and, in broad terms, that was the object of most of the measures we announced on Friday.

What restriction on money and credit in general means in terms of interest rates—and this gets somewhat to the point that Congressman

Brown was raising—depends a great deal on the fiscal posture of the Government; that is, the same degree of restraint on money and credit may bring quite different pressures on the credit market, depending upon how the economy is performing in general, but depending, in particular, upon the budgetary position.

It is in that sense that the more relief we get from the fiscal side, the better off we will be in terms of pressures on the credit market. But that should not be interpreted as in any sense meaning a pulling back from the basic objective of slowing credit growth and slowing money growth. Budgetary restraint will make the process easier in the context of credit market pressures, credit market tensions, but it will not change the need to maintain restraint on money growth and on credit growth.

You have emphasized, Mr. Chairman—not just this morning, but repeatedly—the longrun importance of increasing productivity, taking measures on the supply side. The emphasis of our present measures inevitably falls on the demand side. I don't think that there's any substitute for that.

I have read the recent report of this committee with great interest and with great sympathy in terms of the directions that you pointed out, and the kinds of action you pointed to, particularly on the tax side.

These seem to me very welcome at the appropriate time, but I have to emphasize "at the appropriate time." These measures do have, certainly in the short run, fiscal implications and implications for the deficit.

This again adds to the importance of bringing the expenditure side of the budget under control, of reducing expenditures, because the more effectively that is done, the quicker we bring the day when we can responsibly take the kinds of tax and other measures that you have so properly emphasized.

That day is not now, I must add, given the budgetary situation that exists.

Senator BENTSEN. Mr. Volcker, I note that the President has talked about a $13 billion spending cut. But those of us who met for the past 8 or 9 days and nights came up with approximately $16 billion in cuts that we were talking about. And frankly, I for one feel that we ought to do that and feel that we can do that. Concerning the import fee that will be finally translated into a tax on gasoline, I feel that that $10 to $11 billion ought to be held back to see that we get some targeted tax cuts to increase the modernization of the productive capacity of this country.

I think that you really have to hold some hope out there for the American people that we're not going to do the usual thing, of going through the kinds of boom-bust cycles that we have in the past, where each time we end up with a higher level of inflation and a higher level of unemployment.

So I think that you have to start phasing in these kinds of targeted tax cuts, starting some time next year. And I don't think you will do violence to a balanced budget if you use the import fee to take care of that and some moderation of the increase in the social security tax. If you can show that you can achieve that balanced budget, don't you

think that under those conditions, that we can hold out some hope that we're trying to modernize the machinery of this country?

Mr. VOLCKER. I would be quite willing to hold out that hope, Mr. Chairman. I think perhaps our only difference of opinion, if there is a difference of opinion, is that I want to see those budgetary cuts in the bank; I want to see them produced; I want to see that the budget comes out the way that it is projected. I would hope that we get $16 billion in cuts, if you can do that, instead of $13 billion and I want to see that whole rest of the budget, that other $600 billion, held under control.

And once we have demonstrated that—and it's important to demonstrate that partly for the very reasons you suggested—then we can begin considering whether the time isn't right for that kind of tax cut. But I would be very fearful of holding out too much hope—in a sense, so much hope that we go ahead and take some tax reduction and stimulatory measures—and then have it turn out that the budget doesn't come out the way it is now projected.

I would be very fearful of diverting attention and priority from where I think it belongs now, given the evident, critical need to begin moving the inflationary trend and inflationary expectations the other way.

Senator BENTSEN. Let's put a 5-minute limitation on each member's questions. And I hope someone is keeping time on me on this, because I see we have a number of members here.

Let me say, Mr. Volcker, I am going to push very hard to cut this budget beyond what the President is requesting and to get to the $16 billion figure that we had agreed on at our meetings through those 8 days. By the same token, I am going to support the President on the import fee, and then the translation of that finally to a gasoline tax, so that we can see some cuts in taxes that will do something about making us competitive in the world, turning this drop in productivity around.

Now, concerning these credit controls, traditionally we have had the problem that small business has borne a great deal of the brunt of high interest rates and tight money, and so has housing. In putting on these credit controls, it's my understanding that you are trying to shape them so that we can see that this money goes to more productive business uses. And that's a difficult one, I know, and that's a subjective judgment, but will they help the mortgage market?

I see my time has expired, but yours hasn't. So if you would answer the question, Mr. Volcker. [Laughter.]

Mr. VOLCKER. I think you have capsulized the intent of these measures we took on Friday. Again, they were taken against the background of a general policy of restraint on money and credit which will have to continue. But as we look at developments in recent months, there is some sense that that restraint, while certainly biting in the homebuilding area, putting pressure on small businesses, and creating difficulties for farmers, was perhaps less effective in central money markets, with the largest borrowers who have a lot of alternative sources of funds.

So we have taken actions that I think will make restraint more effective in terms of the lending of the largest banks, more effective in

terms of the ability of large companies to raise credit, and also more effective in terms of the ability of consumers to borrow, through this special program that affects credit cards and personal loans, an area where spending has been proceeding quite rapidly and does not have the same productive connotation that you suggested. We have taken those actions and at the same time we are trying to shield as best we can other sectors of the economy from further intensity and pressures.

Again, we can't make credit run uphill. We can not have, positively—nor should we have, really—free availability of money in some sectors of the economy under these circumstances. But we can try to take measures to even out the impact, so that all the brunt does not fall on those particular sectors, and that's what we're trying to do.

Senator BENTSEN. Congressman Reuss.

Representative REUSS. Thank you, Mr. Chairman, and welcome, Mr. Volcker. I am going to inquire into the important special credit restraint program which you are undertaking as of Friday.

In response to the President's use of the Credit Control Act of 1969, I looked into the legislative history of that bill, which I sponsored, and I think the President and you are quite right in using it. Looking back at the House debate on December 17, 1969, I said, in describing the bill:

> We have had in this country now for more than a year a policy of supertight money. That has been the administration's sole way of fighting inflation. The bill before us seeks to give the President the power to do something about it, to control inflation without ruining half the economy in the process.

And the act which ensued from that debate gave, as you know, the President the following power, in section 205:

> Whenever the President determines that such action is necessary or appropriate for the purpose of preventing or controlling inflation generated by the extension of credit in an excessive volume, the President may authorize the Board to regulate and control any or all extensions of credit.

And that's precisely what he did, and that's what you do in your voluntary program, where you turn metaphorical thumbs down on loans for speculation and corporate takeovers, and give a pat on the back to loans for small business, farmers, home buyers, and others.

You then, pursuant to the Credit Control Act, seek to enforce that by requiring monthly reports on how they are doing from the biggest banks, those with assets over a billion, and quarterly reports from those in the $300 million to $1 billion range.

I commend you for that program. It seems to me this is a good case of everybody doing their job. Congress job under the Constitution is "to coin money," and to "regulate the value thereof," and pursuant to that we set up the Fed and then the Credit Control Act of 1969. And the administration, fully respecting the independent Fed, asks the Fed to invoke the Credit Control Act of 1969. You are doing so.

Mr. VOLCKER. Of course, the President invokes the act.

Representative REUSS. He invokes the act, asks you to do it. You don't have to do it. To your credit, you are doing it and I applaud that. And here we are, still coining money, regulating the value thereof, particularly the latter. And hence my interest, because I want to make sure that the Congress follows through.

It is incredible, but my time seems to have expired. So I will ask my question and then ask you not to answer because it would intrude on somebody else's time. [Laughter.]

There will be a second round, won't there?

Senator BENTSEN. I'm sure there will be, but go ahead.

Representative REUSS. I will state my question, which is: Exactly how are you going to carry this out? I would hope and trust that you are going to ask all of the affected banks, some hundreds of them, to report to you the state of their loan portfolios on March 14—that was last Friday—and then the first of every month you are going to ask them to give a "how are we doing?" report to you. And I want to work out some arrangement this morning whereby, in a nonbumptious way, we of the Congress can carry out our duty to monitor the monitors. Because you can be sure, if we don't monitor, the public is going to monitor us, and that, of course, would be most distressing. So we will come back to that.

Senator BENTSEN. Go ahead, Mr. Volcker.

Mr. VOLCKER. If you'd like my short answer at this point——

Representative REUSS. Yes; just short, because I do want to explore it at length.

Mr. VOLCKER. We have, as you know, in public documents, sent out a program containing certain guidelines to the banks. That is followed by a questionnaire for banks to fill out which essentially does report their present position. Then we will be getting the reports, either monthly or quarterly. That information will include a series of qualitative questions about how they are conducting loan restraint programs and some quantitative information on loan trends and particular types of loan trends. It will also include information on their capital liquidity positions, because we would be particularly concerned about banks which are expanding loans at the expense of maintaining prudent capital and liquidity positions. We contemplate—certainly in cases where the trends raise questions in our mind or where the qualitative information as to takeover loans, loans on more speculative bases and all the rest, raise questions—that we would have what we call a consultative process with the banks involved as we get their reports. And I think we will be following this to the degree we can in between reports and discussing with them the nature of the policies that gave rise to any of our questions.

We expect that process to be quite intense over the weeks and months ahead.

Representative REUSS. Good. We will explore this in my next go-around. Let me just say this. While I would certainly want to leave to the Fed the qualitative business—how is your capital ratio, what is the quality of your loans—I do think that Congress has a duty, and this I do want to explore with you, for seeing that the general headings or rubrics show a nice trend.

Specifically, I want to see a trend whereby the ones you like, which are the ones we like, too—homes and small business and capital investment and farmers—steadily grow; and the ones we don't like—speculative loans and corporate takeover loans—steadily decrease. That way we will get a better mix. And as I say, we will explore that in a moment.

Volcker. Let me, if I may, just make one comment that I think
ant in that connection. This program, in its general terms, is
l to all banks. But the intense consultative process and report-
cess involves large banks. Now, those banks do not have port-
hat are typical of the banking system as a whole. As you would
most farm loans are made by rural banks and most small busi-
ns are made by smaller banks, from whom we will not be get-
orts.
t this out because it is not only the special program that goes
ind of problem that you indicate and that we have been aiming
lso, to the extent that we are successful in reducing the amount
in types of consumer lending that will leave more money—
g money among the smaller banks from whom we are not
reports—for farm loans, for small business loans, and the rest.
now, we took some restraining measures with respect to money
funds, which are justified only by the fact that through the
ns of these funds, large amounts of money—exceedingly large
of money in recent months—were, in effect, siphoned from
try at large. This is money that may have otherwise flowed
loans, mortgage loans, and the rest, which was being concen-
the money markets and made available to borrowers who are
e least restraint.
t is not an unimportant measure in trying to get the kind of
that you are looking for, but it's a little apart from the special
straint program. I just want to point out that's not the whole
ogram.
sentative Reuss. My lips are sealed, Mr. Chairman.
r Bentsen. Congressman Rousselot.
sentative Rousselot. Thank you, Mr. Chairman.
olcker, I was interested in your comment that a policy of tax
is appropriate, but not now. You have read the report of
mittee and you have used one of the trigger phrases we used,
side economics." You are aware that supply-side economics
much the basis of this committee's report, and that we all
on it. In that same report, to match the recommendation for
ng Federal expenditures was an extensive recommendation for
axes as being very appropriate—now at this time.
when do you think the appropriate time will be? You are
with the Kennedy tax cuts of 1963 and 1964. Now we all
at was a different time and place, but the same principles
plied. Why do you want to wait? Why is it not an appro-
ne to take the tremendous cost and load of this Government
cks of the taxpayers of this country and to encourage invest-
savings to get this country going the right way again?
lcker. I was somewhat involved during the Kennedy tax
l.
ntative Rousselot. I know you were. And that's why I am
hat today you aren't supporting the same concept.
lcker. I was involved in that period, and I am also en-
about the concept, in general—until you say "now." The
I recall it—it was a week or two ago, I think—insisted upon
n't want to be unduly cynical or cautious or whatever. I am

enthusiastic for the measures suggested in that program at the appropriate time. But I do think——

Representative ROUSSELOT. When do you think that will be?

Mr. VOLCKER. That will be as soon as you can deal with the spending side of the budget in a credible kind of way and put the spending side of the budget in a position so that, consistent with those kinds of tax cuts——

Representative ROUSSELOT. We are doing that right now in our Budget Committees. The chairman has already mentioned that the Congress is ready to go with even deeper cuts in expenditure. At least the majority of us, I feel, are. Congressman Dave Stockman, myself, and Congressman Gramm presented a list of 26 million worth of cuts to the Budget Committee in the House.

I think there is an awful lot more support for both restraints in expenditure and tax cuts than you judge.

Mr. VOLCKER. I hope there is a lot of support for the expenditure cuts. All I would say, Congressman Rousselot, is God bless that effort; let's see it materialize.

Representative ROUSSELOT. And you will support it?

Mr. VOLCKER. Then let's take a look at the economic situation, the budgetary situation.

Representative ROUSSELOT. And you will support tax——

Mr. VOLCKER. I am an enthusiastic supporter of the kind of tax program that, in general terms, was outlined by this committee—when the budgetary situation, the economic situation, permits it. I would like to see that day come as soon as possible. But I urge upon you that it is not now. It would undercut what we are trying to do in getting this inflationary situation, inflationary trend, turned around at the moment. And that is where our priority must be and must stay until we can see the "whites of its eyes."

Representative ROUSSELOT. As you know, the tax cut part of our report was equally important in attaining the kind of things that you have been talking about: reinvestment in plant and equipment and all of those kinds of things.

Mr. VOLCKER. Over any reasonable length of time, over the years ahead, I think it is terribly important. But let's not destroy that potential. I think it would destroy the potential if, at the moment, all it does is lead to further bursts of inflation and inflationary psychology. Let's get over this hump as quick as we can so that we have laid the groundwork for that kind of program.

Representative ROUSSELOT. The tax cuts in 1963 and 1964 were noninflationary. The war was the thing that gave us inflation.

Mr. VOLCKER. The tax cuts in 1963 and 1964 took place at a time when there wasn't any inflation.

Representative ROUSSELOT. Mr. Chairman, my time has expired.

Senator BENTSEN. Senator McClure.

Senator MCCLURE. Thank you, Mr. Chairman.

I want to follow up on what Congressman Rousselot has been saying, because I feel very strongly that the issue of timing is critical. I commend you very much for the efforts that you are taking. I am glad to see that Members of the Congress are now supporting some monetary restraint and some credit restraint. And I hope that we will

ctually see a majority of the Members of Congress support some scal restraint.

But forgive me if I share some of your pessimism about whether at it actually going to happen. I have been voting that way for years, nd the majority has been voting the other way for years. It is going to quire a reform in their habits as well as a reform in their sense of iorities.

I am concerned about one thing: about timing. I don't believe we n cut the budget rapidly enough to match the increases in expendi- res for welfare and unemployment compensation as business slows wn as the result of economic and fiscal restraints. You know the fficulty the housing industry is having today. I just yesterday got ord that out in Idaho there are 45 housing contractors that within e last 2 weeks have filed bankruptcy. You see the downturn in auto les. This morning you see Firestone closing down 6 plants, 7,000 rkers out of work.

How long are we going to wait before we recognize that there will the need for rebuilding the economy, that there will be the need for ing the various things that this committee has suggested in each of last two economic reports? We have concentrated on the need to k at the supply side. That is something new from this committee d from the Congress.

And yet it seems to me in a degree of caution that we are talking ut breaking inflationary psychology, we are matching that con- n about inflationary psychology by building this on the backs of payers because we are talking about a balanced budget that is ng to be balanced by increased taxation.

n 1976, total Federal revenues were under $300 billion. In 1981 y will be more than twice that. There is a $70 to $100 billion tax rease being projected as a means of balancing the budget.

ow, that is not fiscal restraint. I don't care how you talk about ancing the budget, if you talk about fiscal restraint, balancing the dget by increased taxation, that is a political phony. And I am con- ned that if we keep talking about a balanced budget as being the goal, that we are going to try to convince the American people we balance the budget even if it be by increased taxation, that inflation will be broken, that the economy will be better. And we find out that the balanced budget didn't really produce those re- s. Then what will the American public reaction be?

Mr. VOLCKER. I would put the emphasis on our present problem of ling with inflation. A balanced budget is a means to that end. But me suggest to you—and I find myself in the somewhat peculiar tion of apparently sounding like I am arguing against an ap- ach that I support "at the proper time"—that the most important g, the most important single thing— is to deal with this inflation- situation. I think we have to do that to get the economy back on a wth path and make it more productive and encourage savings and he rest.

he kind of measures this committee has supported and which I port can be very important as they fit into a pattern over a period me that promotes productivity and growth. But we have got to grate this into an approach that is going to deal with this infla-

tionary problem or the whole thing will fail. I am not at all hopeful about those measures, as enthusiastic as I am in supporting them, if the impact—either because they are improperly timed or because other policies are not consistent—comes in the midst of an accelerating inflationary situation that destroys precisely what you are trying to achieve by those measures. So it's a question of priorities and timing.

Senator McCLURE. Mr. Volcker, is your primary goal reduction in the Federal expenditure, or is your primary goal a balanced budget?

Mr. VOLCKER. My primary goal is doing something about this inflation.

Senator McCLURE. All right. In that particular focus, is it a balanced budget, or is it reduced Federal expenditures?

Mr. VOLCKER. They go together. I want to balance the budget by decreasing expenditures, not increasing taxes.

Senator McCLURE. One of those two things is your goal. Which is the important thing?

Mr. VOLCKER. The one that you can operate on, the one that's in that sense not only important right now but in affecting the trend over a period of time, is getting those expenditures reduced.

Now the budget situation ultimately always has a caveat of what's happening in the economy.

Senator McCLURE. But we're holding out to the American people that we're going to balance the budget. Your goal is really to reduce Federal expenditures. I share that goal. We say we will reduce Federal expenditures, but we are increasing taxes in order to do it. So all we are doing is reducing what otherwise would have been a bigger increase.

Mr. VOLCKER. The inflationary process increases taxes, and part of that tax increase you are referring to stems from the process. I don't want to retreat at all from the idea of a balanced budget, but I want to put the emphasis as follows: "Let's achieve that and get into a condition to achieve it by reducing expenditures." And as that expenditure trend is changed—and I just have to repeat again, as we turn around this inflationary situation—then we have laid the groundwork to go ahead with the very constructive types of measures that this committee has recommended. I think you would give an entirely false signal and a damaging signal to the American public by expressing thoughts that in the midst of this situation we can have a big tax cut; that bothers me right now.

Senator McCLURE. Mr. Chairman, my time has expired, but at this moment, let me comment, it's a very bad signal sent to the American public if we tell them a balanced budget is going to break the back of inflation. We take those steps to reach a balanced budget, and we don't break the back of inflation, and we have a recession, and we don't balance the budget because revenues drop off and expenses climb.

Mr. VOLCKER. I understand your concern, and I don't want to be interpreted as suggesting that the only element in an anti-inflationary program is balancing the budget. I think, among other things, we have something to do about that in our monetary policy.

Senator BENTSEN. Senator McGovern.

Senator McGOVERN. Thank you, Mr. Chairman.

Mr. Volcker, I share your view that inflation is the No. 1 concern, and I don't think anybody has worked any harder to address that

problem than you have. But I have spent a lot of my time in the last few months talking with people in my own State, particularly ranchers and farmers and business people and others—automobile dealers, farm equipment dealers, contractors—and they are increasingly concerned about their heavy reliance on high interest rates as a means of controlling inflation. And it does seem to me that the impact of that, at least in the short run, may even be inflationary in that all of these groups that I've mentioned operate with some borrowed credit. So if the cost of that goes to 18 or 19 or 20 percent, it's an inflationary factor.

In the long run, it may break a lot of these people, so that you end up curing inflation, but only at the price of killing the patient. I just wonder what your answer is to that concern.

Mr. VOLCKER. Let me try to answer that as directly as I can; I hope I don't appear to be splitting hairs in an unreal way, although I'm going to split a hair right now. It's not really a hair, it's a fundamental point.

We are not deliberately trying to push up interest rates. What we are trying to do is restrain the growth of credit, restrain the growth of money, because we think ultimately that is fundamental to dealing with inflation. Inflation is fed by expanded use of credit, expanded use of money; our policy is aimed at reigning-in that excessive growth.

Now, we have a situation where the economy has been expanding, has been relatively fully employed; we have very sizable budgetary deficits, we are getting more credit demand, more demand for money at a low level of interest rate than is consistent with our effort and our requirement to reign-in the growth of money and credit. What's happened is that the interest rates have gone up in an effort to balance out this process, which has some of the side effects that you suggest.

As I was trying to say earlier—and very much relevant to the discussion we just had—is that just looking at the budgetary problem, to the extent that the Federal Government goes ahead and adds to those credit demands as it has this year in very large amounts—those pressures on the market and pressures on interest rates are exaggerated. If you are looking for a better balance in economic policy, you will get it, in my judgment, by dealing with that deficit situation with the emphasis on the spending side.

That is what this Congress can do and what the administration can do to relieve the kinds of pressures you're talking about. Now, when I say "relieve those pressures," that does not mean, Senator McGovern, a change in our policy of restraining the growth of money and credit; it stays consistent with those policies. You should have less pressure on the money markets as the Government moves toward fiscal restraint, and that's, of course, what I would like to see but, if we do it on the spending side and prematurely take it back on the tax side so to speak, I don't think we will have accomplished our purpose. We may have exacerbated the immediate situation.

Senator MCGOVERN. Isn't there a different argument that prevails with regard to people that are borrowing money for production purposes over against those who are borrowing for consumption purposes? That is, a farmer who wants to plant a crop or a rancher who

want to build up his herd stock or a businessman that's laying in an inventory, they have to borrow; there is no other way to function. And for whatever reason, when those interest rates and the tight money policy combine in such a way so that they end up either being denied credit or have to pay for it at an exorbitant rate of 18 or 20 percent it seems to me that that defeats the whole productivity concern that this committee and others have expressed. And beyond that, it works an inflationary hardship on people whose production we depend on.

Mr. VOLCKER. In general terms, we can try to make that distinction, and we are trying to make it in these measures that we took on Friday, to the extent that we can. But let me just introduce a footnote, or perhaps a little note of realism, that Congressman Reuss referred to earlier. It's often hard to make a distinction between productive and nonproductive credit.

Any particular borrower will have a string of reasons why he is not borrowing too much or contributing to inflation and why his particular loan is justified. And even borrowers who are engaged in clearly productive activities sometimes have alternative ways of proceeding, other ways of raising money. So the distinction is not black and white. It's very hard to find a particular business and say, "You've got a black hat, and the other fellow has got a white hat in terms of what he's using his money for and how useful it is in terms of the future of the country."

I think we can try to make a distinction; we are trying to make a distinction. But a generalized program of restraint tends to be felt every place, as perhaps it should. The impacts have been uneven; we are trying to even them off as best we can using the tools that we have to work with and given the difficulty of making these distinctions.

The pain extends to almost everyone. We have been talking to quite a few people in recent days, as you can imagine, and the initial reaction of consumer credit people is, "Why us? I mean, we haven't been expanding in the last few months at that great a rate of speed." But with the kind of criteria that you put forward, that is an area which, on the face of it, seems less destructive—if I can put it that way—as compared to restraint in other areas.

I talked to all the big banks in the country on Monday. We had bankers in to explain this new program, and you can be sure that they began to raise their hands and say:

> Well, you know the kinds of loans that I make are very constructive for the future of the country, and I don't have any of those other kinds of loans that are not constructive.

So we have to say:

> Well, that's fine, but we expect some overall restraint, and we do expect you to make the kinds of judgments that are involved.

Senator MCGOVERN. Thank you. My time is up, Mr. Chairman.

Senator BENTSEN. Senator Jepsen.

Senator JEPSEN. Mr. Volcker, I would like to make some observations and then address my question to you on the basis of your capacity as the Chairman of the Federal Reserve Board, because in the area of leadership—and I think getting a handle and conquering, if

you will, or getting under control this thing called inflation—a lot of psychology is involved in it, a lot of psychology relating to leadership and resolve and commitment. What has gone on, even at this meeting to a degree, and constructively is that there has been some fingerpointing trying to fix blame. I think that we have got to stop pointing the finger and fixing blame, and get about working together to fix the country and our economy.

I was on a panel the other day with Van Dorn Ooms from OMB. He said that people have to earn a tax cut. I keep hearing these things, and I begin to wonder what comes first, the chicken or the egg, or what kind of button-button-whose-got-the-button type of shell game is this?

You don't hear the talk that this is a joint, mutual venture that has got to be shared by all of us. At the same time we tighten credit, we have to encourage investment and savings. We have to increase productivity. All of this has to take place simultaneously.

I firmly believe that until the people of this country believe that there is a commitment to really, truly get a handle on inflation through some sort of a mandated balancing of the budget and a limitation on spending that our inflation is not going to stop. It's going to continue, and we're going to continue to get what you and I heard at our breakfast the other morning. One gentleman said that he bought some land. I asked him why he bought land. He bought land because it is a hedge against inflation.

After leaving that meeting, I went back to my home State in Iowa, which is a very depressed State. Senator McGovern has alluded to a lot of similar things in Iowa that he has in his State. And I confidentially discussed with a business owner, a very successful manufacturer, the fact that he had called a board of directors meeting a weekend before, and they had visited for about 3 hours about the economic situation and then made the corporate decision to quitely increase all of their prices 8 percent because their suppliers were doing that to them, and they were doing it just in case.

Can you point out, as a leader and privy to the plans of the administration, where this commitment is? I don't disagree in this, but I don't get that commitment from the President's announcement as to his approach. The balanced budget has been around for a long time. That talk is not new. A lot of people now sound like they invented it, but it's been going on for some time.

The fact that we took and pointed the finger and we're going to punish some of the people for spending so much money—we're going to raise their gasoline tax; we're going to get at them with a credit card—but I don't yet see the commitment by this administration or by the leadership in this country, short term and long term. The only thing I got the other day from that was sort of like a band aid for dysentery type of operation.

Where is this long-term commitment?

Mr. VOLCKER. I hope you are misjudging the situation, Senator. Obviously, only time can tell. But the one thing that is encouraging to me is that I do sense a change in the mood of the country. I'm not a member of the administration, but I sense a change in the mood of the administration, a change in the mood of the Congress that recognizes the importance of dealing with inflation.

It is symbolized in part by this talk of a balanced budget. As you point out, we've had a lot of talk about balanced budgets. We haven't had any actual balanced budgets for a long time.

But I do think that the mood is changing. I don't say that proves the case. In terms of my own responsibilities, it does seem to me that the greatest disservice I could perform in that connection is to suggest that I've got some magic formula for easing off from restrictive monetary policies under these conditions. I do not.

I think we're going to have to maintain that restraint on money and credit growth. I think it's important that the burden be as evenhanded as possible, but we're going to have to sustain it if we're really serious about this inflationary problem. And I hope that the Congress can sustain the kind of momentum that's been mentioned here this morning.

I can't give you any further answers on that, except that I do interpret what's going on somewhat more optimistically than your comments suggest you do. This is a tough, tough period; people can talk in the abstract about it being tough, but when it hits home—when that farmer out there has difficulty with his bank in raising his money or that automobile dealer or that homebuilder is in trouble, or that big businessman has more difficulty raising money—then, in a generalized sense, the importance of balancing the budget and cutting spending becomes clearer to them.

They are reluctant, to say the least. And there has to be an impression that this burden is shared, as far as possible, as you suggested.

I am somewhat encouraged, somewhat optimistic, that there is an understanding of that and it's growing. I have really been impressed—even in my contacts with homebuilders and people in thrift institutions that are under very heavy pressure—by the extent to which people have said, "We understand what you are doing. We just want to get through this period as quickly as possible."

I share that thought. To get through that period as quickly as possible, we have got to stick to our guns, and I think that you've got to stick to your guns on the budget. That is one reason why I am fearful of premature talk about what I think is a very constructive approach on the supply side. It can come, but let's create the conditions under which that can be the program of the day.

Senator JEPSEN. May I make just one clarifying remark?

I understand you are not part of the administration. I can understand why you also want to make sure that it's understood that you are not part of the administration. [Laughter.]

But you were appointed by the President and I assume that he asked you for advice.

Mr. VOLCKER. Yes. We had quite close consultation on this program and, of course, we chose to announce our measures in a coordinated way because we feel that the program, as a whole, is a coordinated program and should be presented in that way.

Senator JEPSEN. Thank you, Mr. Chairman.

Senator BENTSEN. Congressman Brown.

Representative BROWN. Thank you, Mr. Chairman. Would ending Federal deficits and Federal borrowing make slower money and credit growth easier to bear and to stick with, Mr. Volcker?

Mr. VOLCKER. Yes.

Representative BROWN. Do you view fiscal restraint as supportive of a policy of controlling money and credit growth, or as a substitute for controlling money and credit growth?

Mr. VOLCKER. Supportive—for the reasons I tried to explain here: That we will maintain restraint to the extent that we reasonably can over the growth of money and credit, and that process is facilitated by restraint on the budgetary side. It will enable us to achieve restraint with less of an effect in the credit markets, with less strains and tensions. But fiscal restraint is not a substitute for restraint on money and credit growth.

Representative BROWN. It seems to me that the Fed, if it created, say, $20 or $30 billion less new money each year, that this would not necessarily impose a hardship on the private or local government borrowers, if the Federal Government had cut back its own spending, say $20 or $30 billion, and therefore made less demands on the credit market. Is that correct?

Mr. VOLCKER. Yes.

Representative BROWN. Well, the administration keeps telling us about a $13 to $16 billion cut that will balance the budget. CBO puts the deficit at $25 to $30 billion. Evans Econometrics says it is over $30 billion. And Schroder Bank puts the deficit at $44 billion. Also, the interest on the national debt in fiscal year 1981 is supposed to increase by $16 billion.

How is a $13 to $16 billion spending cut going to balance the budget? Or perhaps more importantly, to get the Federal Government to reduce its demands on the credit market?

Mr. VOLCKER. Some of those other estimates you see in the budget project the point that I tried to emphasize at the start; they assume that the Government is going to overspend by a substantial margin.

Representative BROWN. Isn't that always the case?

Mr. VOLCKER. I don't think it's always the case. A few years ago, there was a period of underspending; certainly that's the case in the current fiscal year by a very large margin.

That is why I emphasize that this isn't just a budget cutting exercise, in the sense of taking $13 or $15 or whatever billion out of existing programs; rather, it's equally important to prevent those overruns in the parts of the budget you are not explicitly cutting. That can be a very tough job, and I just want to get that point front and center, too. Maybe it's better than doing nothing, but cutting the budget by $14 billion, on the one hand, and letting overspending by $14 billion in other programs, on the other hand, is not the way to start.

Representative BROWN. Could you come to a couple of conferences I'm sitting on and discuss that with the people in those conferences?

Will you tell us about the condition of the banks and savings institutions of this country and what your plans are for lending to these institutions as Federal deficits drive them to the wall?

Would you not literally be forced to reverse your policies if Congress doesn't finally bring a halt to the orgy of spending that we have been through?

Mr. VOLCKER. There are heavy pressures, particularly on thrift institutions. There are obviously pressures on the banking system, too.

But the banks, because so many of their assets are either short term or on a floating rate basis, don't feel the pressures to the same extent. They have the pressure of not having enough money to lend.

The Federal Reserve, I'm confident, is equipped to take care of particular points of strain, if that ever becomes necessary, without destroying our general policy approach.

But let me say that, viewed from that standpoint, growing pressures on sectors of the financial markets and financial institutions adds force in point, I think, to the effort to deal with this situation as rapidly as possible.

Let's not make any more false starts. Let's push it through to an early conclusion, not in the sense of inflation suddenly disappearing, but in the sense of a trend of turning it around, because then those pressures will ease; they're not going to ease until that happens.

Representative BROWN. You may not wish to answer my last question and I'll let you make that decision. But I noticed that the number of banks on the supervisory problem list declined over the period from 1976 to 1979, but has the squeeze from disintermediation as a result of high interest rates paid for money market funds versus low rates on old loans at those banks or any other adverse development caused more banks to move onto the problem list in recent months?

Mr. VOLCKER. I'm not aware of any particular change in that listing as far as the commercial banking industry, which is what I'm directly familiar with.

Representative BROWN. I can tell you of one area that I know of in which the banks have, in fact, cut off all credit loans for automobiles, for instance, and that the housing industry is on its back in my State.

So I would say the credit controls are already being imposed.

Mr. VOLCKER. There's no question that restraint is effective in the homebuilding industry pretty widely. I must say, given the extent of restraint in terms of most historical comparisons, the impact has by no means been absent—it's very great now—but it's taken longer in coming than one would have thought, partly because the inflationary expectations, I think, were so great. What you typically think of in comparisons is high interest rates, and these interest rates are the highest we've ever had in history by a considerable margin, but they haven't bitten as rapidly or forcibly as one might think because of the degree of inflation and inflationary expectations.

Representative BROWN. Thank you, Mr. Volcker. My time is up. I appreciate your answers.

Senator BENTSEN. Mr. Volcker, I really have only one more question. I recall when you first took over your present position, I visited with you and told you that I was deeply concerned that we not repeat the problems of 1974 and 1975 to the extent that we could avoid them, where the housing industry bore the brunt of the fight against inflation.

And I thought that you were somewhat sympathetic to that point of view. In fact, to paraphrase you, you spoke of getting the message across to those lending windows, if it approached that, to try to see if they couldn't ease that problem.

Now I read that February starts from the Commerce Department

on single-family dwellings—and they're down to 774,000—that's the lowest level since the depths of the 1974–1975 recession, when in the first quarter, they were at 734,000.

Now what specifically are you doing to try to help home mortgages for housing?

Mr. VOLCKER. I think it's implicit in those numbers you just gave and the total housing start figure. I don't know about the single-family figure; one would expect it's going to come down further.

In that sense, we were unsuccessful in the kind of concern that you had and that I had and that I think everybody had; that figure is a measure of the extent to which this inflationary game got ahead of us.

In those terms, again—and I just have to emphasize it—the real salvation is in getting a handle on the total situation as promptly and as effectively as we can. We haven't done that so far. We must not fail this time.

There are risks and problems involved in that process. It's inevitable at this stage. All I can say is that those risks and problems, including the condition in the homebuilding industry in particular, get worse to the extent that we fail to handle on this round. We must not fail. That industry recognizes that. Obviously, they are upset; they are concerned. But as I say, when I talk to people in the homebuilding industry, what they say they would really want to see is progress on the total situation, because they know that that industry can only really prosper and continue to grow in an environment of more stability.

That is where the focus has to be; that is far more important than any special measures that can be taken, including the measures that we are currently taking to try to even out this process.

Senator BENTSEN. Mr. Volcker, I agree that they prosper best in a period of stability. But they are experiencing the greatest instability of probably any economic sector.

And I don't know how in the world we ever get real progress and productivity in homebuilding and get the prices down unless we have some continuity of effort. If it's a boom and a bust, you know, we have new firms created and then firms going out of business, not being able to make the capital investments where they can have a return over a stable and a relatively long period of time.

This is the kind of cycle that we have seen in homebuilding.

They are the ones that we squeeze out first in this kind of a monetary approach.

And I would hope that we could find some way to help here—last time it was—as I recall, it was the Brooke-Cranston Act that gave us some secondary market for home mortgages.

And I would urge on you to find some kind of way to stabilize what is happening in homebuilding.

I see Congresswoman Heckler has just arrived and I call on her now.

I apologize to you. I'm scheduled to make a speech on the floor at this time.

Representative HECKLER. Thank you, Mr. Chairman.

I have the same concerns that Mr. Volcker has just expressed, having been a member of the Banking Committee for several years, and now on the Joint Economic Committee. The boom and bust cycle for

housing continues, and I am particularly concerned about the plight of the thrift institutions, not only the housing industry but the thrift institutions themselves. There are many of them that are in grave difficulty. A certain number will be unable to survive, and this is a serious, a very serious problem.

Now, I agree with you that the economic stability of the country is our No. 1 concern. But if our major thrift institutions are in such jeopardy, I question how much economic stability we can achieve through operations in other sectors. I think the thrift institutions represent about $780 billion, as I understand it, in assets. And one of the things I'm wondering about now is that, in view of the fact that the conference committee has reported out the Omnibus Banking bill, and that reserve requirements will be placed on thrift institutions, and that statements have been made, I believe, by you and by your predecessor that the Federal Reserve would open its discount window to thrift institutions, I wonder what would the conditions for access to the discount window be for these institutions?

Mr. VOLCKER. I believe that that bill, as it's now written, would provide access to the discount window for those institutions directly upon passage of the bill. We will have to consider in detail the precise, ordinary access so that it's analogous to the ordinary access our member banks have had in the past.

But we also have now, as you know, the capacity and facility for lending to institutions in an extraordinary way if they are in particular difficulty. I think such arrangements could be made whether or not that bill passes, but that bill will make it simpler mechanically to take care of particular points of strain or pressure of a more or less emergency nature, should those arise.

Representative HECKLER. In the case of borrowing from the Federal Reserve, would you be willing to accept the FHA or Veterans' Administration loans as collateral?

Mr. VOLCKER. Yes, we do now; that would involve no change in our basic practice.

Representative HECKLER. What range of conditions are you considering in order to make it possible for thrift institutions to have access?

Mr. VOLCKER. We will undoubtedly establish some arrangement where they will have limited access, as member banks have limited access, in their ordinary activities.

I think the question that you are really addressing yourself to is a more extraordinary situation, where an institution has some difficulties. Those arrangements are by their nature special and shaped to particular circumstances at the time. I think it would be difficult or impossible for me to lay out a general condition, because the arrangement has to be shaped to particular circumstances. But the capacity is certainly there.

Representative HECKLER. Well, just how serious are you going to allow the housing crisis and the problems of the thrift institutions to become before some action is taken?

Mr. VOLCKER. If I may be so presumptuous, I will turn that question around and say: to what extent is the Congress going to relieve those

pressures by dealing with the budgetary situation that we talked about earlier? That is an important ingredient in the pressures and strains that we have on financial markets. I think that is the relevant question, as I see it, a part of the relevant question.

The other part is that we stick with our policy so that we begin to see a turn in the psychology and in the markets. As I said earlier—I think before you came in, Congresswoman Heckler—I don't think we would be doing anybody a favor by adopting policies that were sure to lead to a persistence and a worsening of the inflationary situation, because that is the fundamental circumstance that has produced the strains to which you call attention.

If we merely perpetuate the process, that would be the worst thing that we could do to those institutions. We can deal with the short-term situation of the vast majority of those institutions. What would be of concern is if this situation just persists and persists and persists; we must make sure that doesn't happen.

Representative HECKLER. I would just like to ask one final brief question, and that relates to our anticipation of recession. For a year and a half we have, I think, been very anxious on this committee and all the other financial committees of the Congress, anticipating a recession. And the anxiety seems to have—at least earlier, seemed to have been unwarranted.

But the financial signs now are becoming more ominous. Has a recession begun?

Mr. VOLCKER. You asked me precisely that question last time I was here, Congresswoman Heckler, only a couple of months ago.

Representative HECKLER. I'm glad you notice my question.

Mr. VOLCKER. I said I hadn't seen that it had begun yet. But I'm never quite up to date—nobody's quite up to date—on what's happening at the moment. I still say I haven't seen it yet.

The fact that that question gets asked all the time, asked by everybody, is perhaps symptomatic in part of how we got into this problem. For a year everybody has been anticipating a recession in the next quarter and saying, "Well, look, don't push too hard, because almost everybody says there is going to be a recession next quarter. Let's not work too hard on the budget, let's not work too hard on monetary policy, because the bottom is going to fall out next quarter."

That's been said every quarter as the year proceeded. But the outstanding characteristic over the past year is that the bottom not only has not fallen out, but demands have remained very strong. I do think there is a probability of some kind of softening of the economy; I think that remains true. I would have said that and did say that 6 months ago. Sooner or later it's going to happen.

But what we know is we have a clear and present danger of inflation, and we have to aim our policies at that problem.

Representative HECKLER. My time has expired.

Representative REUSS [presiding]. I promised Mr. Volcker to stay here until the end of our period, because if I leave our Republican friends might enact an immediate, across the board tax cut. [Laughter.]

Representative ROUSSELOT. You're right. [Laughter.]

Representative REUSS. Congressman Rousselot.

Representative ROUSSELOT. Mr. Volcker, why should we have withholding on interest and dividends? Can't the IRS check for cheating by matching the 1099 reporting forms from banks and corporations with the people's tax returns? And why impose this additional paperwork burden on the private sector? Most of those people pay—if they are not paying withholding tax on a regular salary check, they have to report quarterly anyway. So why this extra paperwork burden?

Mr. VOLCKER. I suppose I should say that question could more appropriately be directed to the IRS.

Representative ROUSSELOT. I know it should be. But you are obviously involved in this policy area to a degree, too.

Mr. VOLCKER. I think you know the considerations on both sides there, Congressman Rousselot. There is a feeling at the IRS and elsewhere that, for whatever reason, taxes that are owed on interest and dividends are not being fully paid, and that this would be a more efficient collection mechanism to avoid that tax evasion.

Representative ROUSSELOT. But with it goes all kinds of paperwork.

Mr. VOLCKER. There's a certain amount of paperwork, of course, already in the information returns you refer to. I understand this is a matter that has been of some controversy for a good many years.

Representative ROUSSELOT. Yes, sir, I'm glad you recognize that, especially for our constituents that call us directly.

I would like to come back to these tax cuts that you would support at some time, you say, but not now. Part of our problem in facing this 1981 budget, as you well know, is that even if Congress does nothing, we will have a $1 billion increase in tax revenues. Some people say it may be even as high as $100 billion.

That's if we do nothing. Therefore, I can't understand why you continue to maintain that the time isn't now, because this is an automatic increase. Wouldn't it be prudent and proper to have some kind of tax reduction just to keep up with inflation, for the people who have to pay these taxes, assuming Congress is willing to couple it with adequate expenditure reductions?

Mr. VOLCKER. My difficulty is that we seem to have an inexorable and semiautomatic increase in expenditures, too. We've got to look at both sides.

Representative ROUSSELOT. But most of the people sitting here aren't voting for that. As a matter of fact——

Mr. VOLCKER. Some of them you don't have to vote for; they're automatic.

Representative ROUSSELOT. Yes. That's my point. Now, as you know, the last six times we have had a budget resolution on the floor of the House, I have offered a balanced budget resolution, with both expenditure cuts and reductions to the taxpayer. I tried to justify it with the proper economic paperwork to back it up, figuring the factors.

What I can't understand is why a person who was involved with and knew and understood the Kennedy tax cuts, and who saw what the end results were, can't agree that we should do the same thing now to moderate the tremendous increase in taxes that will occur automatically if we do nothing.

Mr. VOLCKER. You know I would like to see a tax reduction.

Representative ROUSSELOT. Let's get at it. We need your help.

Mr. VOLCKER. I have got to look at the entire situation. I honestly think the most effective help I can give you is to emphasize the need to get after the expenditure side of the budget.

Representative ROUSSELOT. We all agree with that.

Mr. VOLCKER. OK, let's do it.

Representative ROUSSELOT. We said so in our report.

Mr. VOLCKER. I respect that report; it was an enormously useful report. But I haven't seen the expenditure cuts enacted yet.

Representative ROUSSELOT. I'll send you over the list that a bunch of us put together in the House, $26 billion. I think we sent it to your office. It was a good solid laundry list that we worked on a long time.

Mr. VOLCKER. I appreciate that; I have no question about that. But however interesting, useful, valid your list is, it's not the law of the land.

Representative ROUSSELOT. We're going to offer it on the floor when we get to the budget resolution. We will also offer some tax cuts. And as you were an author and interested party in the cuts made in 1963 and 1964, I hope you will help us to get some tax cuts to modify the incredible $92 billion increase in tax revenues that's going to occur. As you know, this increase is outrageous and will not encourage the private sector to produce more jobs.

Mr. VOLCKER. I sympathize with what you are saying, but let's do it in a responsible way. Let's recognize the problem that we have, this overwhelming problem of inflation, the fact that we have a huge Government deficit at the moment and that the priority has to be to get that situation turned around.

I could not be more conscious of the fact that in the longer run perspective we are dependent on getting productivity up. We want to see more business investment. The Tax Code and regulatory areas, which haven't been mentioned here this morning, are also very important. There are things that we need to work on to provide the kind of 1980——

Representative ROUSSELOT. By the way, on our list of expenditure cuts we have an across-the-board cut for the regulatory bodies in expenditure level. They are just out of hand, too, and you're definitely right on that subject.

Representative REUSS. Mr. Volcker, I'll now ask my question. Can the Federal Reserve supply to the Congressional Banking Committees the information reported by the banks on a monthly and quarterly basis under the special credit restraint program, so that we may play our part in seeing that there is a progression away from the inflationary loans and toward productive loans?

Mr. VOLCKER. I would like to look at what we could provide on an aggregated basis. I assume you're talking about an aggregated basis.

Representative REUSS. As I said before, we wouldn't want judgmental matters. We don't want to become bank examiners, nor do we want to get into the area of your discretion. But we would like to know where were the banks on March 14 in terms of the good ones and the bad ones? And how are they doing?

I wouldn't expect them all to progress toward the new Jerusalem in equal pace. But if "X" bank, for instance, suddenly came out with a crash of speculative or takeover loans and was cutting down on the others, you would want to get an explanation. So would we.

Mr. VOLCKER. I would be very surprised and disturbed if we found that pattern.

Representative REUSS. We want to be in a position where we can avoid such surprising disturbances ourselves. But if you, in passing this information to us, wish to classify as secret anything you pass up, we will respect that classification. But I can't really imagine why the success of the Nation's credit program should be a big State secret.

Mr. VOLCKER. The success of the credit program cannot, by its nature, be a State secret. I think what we're talking about here is the confidential data of individual banks, if I understand your question correctly. That is, I think, a different matter.

Representative REUSS. What's confidential about the fact that the First National Bank of whoever has $1.2 billion in its loan portfolio, and that the percentages of that portfolio devoted to your rubrics, small business, housing, speculation in commodities, corporate takeovers, are as follows? That's what I want.

Would you consider this as a request for that? And I would hope you could honor it.

Mr. VOLCKER. I certainly am completely unwilling to consider what kind of information might be useful to the Congress, but I'm not going to make any commitment here this morning to provide individual bank data.

Representative REUSS. That's fair enough, but you don't have any doubt about what I'm asking for, do you?

Mr. VOLCKER. I understand in a general way. Let me come back to you with some idea of what kind of information might reasonably serve your purposes.

Representative REUSS. This is essentially a who shall guard the guardians, who shall monitor the monitors. Since Congress gets monitored by the voters on what's happening to housing and small business and the rest, I'd like to be in a position to tell them how our financial institutions are doing.

Mr. VOLCKER. I certainly think we can provide you with information that will satisfy your concern about how the program, as a whole, is progressing and what the trends are in the banking system.

Representative REUSS. I want to know what the bank of so-and-so is actually doing. But anyway, you have my request, and you either honor it, or you tell me no, and then we will have one of those stimulating dialogs that I always enjoy. [Laughter.]

Now, a little bit about your list of goods and bads, which I think I commend you on. But there is one good and one bad, at least in my calculus, which is absent.

Why don't you include among your goods—you've got small business, farmers, and home buyers—why don't you include productive capital investment?

Mr. VOLCKER. We thought that was implied.

Representative REUSS. I don't really think it is. Small business, yes; farmers, yes. But I very frankly have nothing against big business making a productive capital investment. It's all right with me.

Mr. VOLCKER. We don't either, and that's, I would have thought, the thrust of this. Some people are allergic to the particular terms "productive" and "nonproductive."

Representative REUSS. Strike productive. I'll settle for capital in-
stment.

Mr. VOLCKER. We are conducting a program of loan restraint. I
assure you that there will be people out there saying they have
oductive investments that, in the aggregate, will total about twice
amount of available credit. There aren't many banks, I assure you,
t are going to come into us and say, "Gee, we just made an unpro-
tive loan yesterday."

Representative REUSS. I said, "Strike the productive," if that
hers you. Just say, "Capital investment, as recognized by the U.S.
easury in its investment tax credit regulations."

Mr. VOLCKER. I think that's implicit here. But we will make it clear
t we are aiming particularly at productive investment or capital
estment.

Representative REUSS. Think it over, whether that shouldn't be
ed.

Mr. VOLCKER. This is more a negative list than a positive list, in a
e.

epresentative REUSS. It's possible. It should be and is a positive
And I applaud you. But I think the degree of positivity should
nhanced by including capital investment or business fixed invest-
t, whatever.

ne bad that you haven't listed, you come down, as you should, on
orate takeovers and speculative holdings of commodities, precious
ls, or extraordinary inventory accumulation. What's wrong with
ng speculative holdings of land? I think that's a big trouble-
er.

r. VOLCKER. I don't disagree with you. I think we had a sentence
ng land development, whether or not well-developed plans——

epresentative REUSS. You're giving a template here, a matrix, and
nt to make sure it's perfect. Consider adding land to that.

r. VOLCKER. It's not going to be perfect, if I can say that, Mr.
s. The philosophy of this program is that the banks cooperate
recognize the spirit of this thing, and I think that they do so.
urgent and necessary that they do so. That's why we had this
ltative process. We have to leave a certain amount of judgment
em as to which purchase of land is, indeed, something that should
nably be cut back to free up funds for other uses, and which
ase of land may be for a builder who wants to develop a tract
e next few months consistent with our desire to maintain the level
mebuilding. That kind of judgment is awfully hard to write in
tence.

presentative REUSS. But you didn't boggle at putting in inventory
nulation and holdings of commodities. There are good ones and
nes. I want you to be a still small voice inside the banking system.

. VOLCKER. I don't want to suggest we can be perfect in detail
bstitute for the bank's judgment. My associate points out to me
cific questionnaire—and this will delight you, I hope—where we
bout speculative loans. It says, specifically, "Loans for invest-
in land without well-defined plans for its useful development."

presentative REUSS. Beautiful. We are together. And the only
I upbraided you here was I was reading from your press re-
where through an innocent oversight——

Mr. VOLCKER. The question there is a little bit more detailed.

Representative REUSS. You are on the right track, and if you can keep us clued in as to what the banks are doing, that will be very helpful.

And may I suggest that if the banks know that we are clued in on it, they are likely to hear that still small voice even louder, which will help you. We want to help.

Mr. VOLCKER. I understand.

Representative REUSS. Thank you.

Senator Jepsen.

Senator JEPSEN. Thank you, Congressman Reuss.

In trying to get a clue, which I, and I think about 200 million others in this country are trying to do, of just where this administration is going, what direction it has and what resolve and will toward getting a handle on this, I want to go back to my area of comment that I referred to before. I would just like to list four simple things, one at a time, and ask you, Mr. Volcker, if you would feel that this was something you could support at this time, at a later time, or not at all?

Let's pretend for a minute that the administration would announce that there be an immediate moratorium on all new regulations; that further, it would immediately appoint the members—some members of the administration and some members of the legislative bodies, form an action committee to review all regulatory agencies with regard to their activities, generally, without getting into detail, with the resolve to come up with some kind of report on the balance that we ask and talk about with regard to regulatory activities and how it affects our economy, and to have this back in 4 months; and that if there was anyone, at least in the administration, that felt that they could not do that, that maybe they ought to seek other employment—in other words, get some resolve in that area. How would you feel about that?

Mr. VOLCKER. I applaud the spirit of what you're saying. I don't know whether you're thinking of a congressional act.

Senator JEPSEN. I'm not thinking of that. I'm thinking of an administration and leadership doing what, by Executive order, could be done, and should be done, in my opinion.

Mr. VOLCKER. My understanding, Senator, is that the administration had some thoughts along those general lines, but it was immediately pointed out that there are now so many laws that require new regulations that it would not be doing much to wave the flag and say the administration would put on a moratorium.

That's not within its area of competence, because virtually every new regulation coming out is mandated by law.

We have quite a few within the Federal Reserve that I groan about. But, you know, the law says you get a regulation out there by April 1, or whenever, and I don't think there is any Executive order that can override the legislation. If you want to accomplish that result, I think you're going to have to pass a law.

Senator JEPSEN. Again, just talking about reasons why we can't do it, do you think the idea is good?

Mr. VOLCKER. I think the idea is good.

Senator JEPSEN. A lot of this is professional footdrag, bureaucratese, and all the things you get from this "happiness academy" back

here in Washington, D.C. All the reasons why we can't do something that needs to be done. We do all kinds of things that don't need to be done. And it's unbelievable.

Mr. VOLCKER. If you can get that done, I am with you.

Senator JEPSEN. Two, the same type of thing, to issue a directive to cut redtape, facilitate and expedite export marketing activities. Go in and set up an administrative executive committee into the Commerce Department, the U.S. Department of Agriculture, and others, and get the same type of similar review and report back in 4 months. Do you have any problem with that?

Mr. VOLCKER. No.

Senator JEPSEN. Three, an administrative commitment by calling for and supporting some form—without getting into whether it be a constitutional amendment, statute, whatever it is—some form of a mandated commitment to balance the budget and limit Government spending, not only this year, next year, 3 years from now, 4 years from now. Tie that in with 5- and 10-year projections; illustrate what they mean when they say "balanced budget and limited spending." But mandate it. Supporting a mandate to do it.

As I say, confession is good for the soul. I have been here 1 year and 2 months. I am absolutely convinced—I am not proud to say it—but that the 535 elected officials here are not going to do this other than maybe momentary, not on a permanent basis.

Now, I believe it should be mandated. I think there is a growing concern and a support for that in this country. What if the present administration asks you, "Should we do this?" what would you tell them?

Mr. VOLCKER. Yes, I would like to see something done in this area. But let me say I am not at the point of thinking this is appropriate as a constitutional matter. There are lots of problems, I know, in any of these approaches. But I find myself increasingly sympathetic to the idea that setting, through some kind of legislation, an overall spending limit—even recognizing that Congress can undo in the future what does today—is perhaps a useful device to emphasize the importance of this problem and your intent.

There are all kinds of complications in actually writing such a piece of legislation; I am aware of that. But it makes more sense than the kind of debt-ceiling exercise that we have gone through in the past, which comes at the end of the budget process instead of at the beginning of the process.

Senator JEPSEN. I have some more on the laundry list. But thank you for your candid answers. My time is up.

Representative REUSS. Thank you. Senator McGovern.

Senator MCGOVERN. Thank you, Congressman Reuss.

Mr. Volcker, I am sorry I had to be out of the room quite a bit this morning. We had Secretary Vance before the Foreign Relations Committee, so I have had to divide my time.

But I want to ask a question now that probably is backward. I should have begun with this. And that has to do with the causes of inflation as over against the cure. And I would like to just give you my own amateur view on it, and then have you react as to whether I am on the right track in terms of the causes.

I list, first, the Vietnam war, at least after 1965, and the buildup that occurred for the next 7 or 8 years. Second, two unprecedented things that happened after we pulled out of that enterprise in 1973. The first of those was that for the first time in the 200-year history of the country we increased military outlays after a war rather than substantially curtailing them. I don't think that's ever happened before in American history, that we went up on the military expenditures in the postwar period. And simultaneously, in 1973, you had the oil embargo and the end of low-cost plentiful energy.

A fourth factor is the comparative decline in U.S. productivity. What caused that, I don't know, whether it's a lack of management, wit, and imagination, or whether it's the fact that we are so preoccupied again with putting R. & D. into the military development that we have neglected our civilian industry.

And then the final factor is one that is usually mentioned first, and that is the Federal deficit. It would seem to me that the personal deficits most of run is probably more significant than the Federal deficit, but let's list that as five.

Does that come anywhere near to your own explanation of how we have gotten into this inflationary bind that seems to be so tenacious and stubborn and resistant to the things we are doing to cure it?

Mr. VOLCKER. Let me try to answer in this way, Senator McGovern. I think you pointed to a number of things that obviously and specifically had an influence in the last decade or so on this accelerating inflation. The failure to finance the Vietnam war properly was certainly one factor. I don't know about the defense spending thereafter; I don't think that change is of a magnitude that I would give it the same priority that you do. Certainly, the productivity problem makes it more difficult and adds to inflationary pressures. Oil is a very obvious problem. So are the Federal deficits.

In my own analysis, I look beyond the specifics and ask why? Why wasn't the Vietnam war financed correctly? Why did we permit the Federal deficits to build up? Why didn't we meet the oil problem more forcibly? Why haven't we given more attention to productivity?

And I sense a more general answer: That we had inflationary concern fairly low on our priority list, whatever the oratory was. Our concerns were elsewhere. They were with, let's say, the management of the Vietnam war and that particular episode. More generally, as I was suggesting to Congresswoman Heckler earlier, the predominant concern has been over any hesitation in the economy; and, if we were going to have a choice, the choice was always made toward expansion. A lot of those forecasts of recession turned out to be wrong, but we were left with the expansionary policy because that was some appraisal of where the risks lay.

All these things accumulate. It didn't appear—and maybe in some sense was not—all that dangerous, when inflation was at a low rate. But the longer this persisted, the longer it became engrained in the psychology. Now we find we have a bear by the tail. It was a very convenient assumption that, as the expression went, "We could buy a little employment at the expense of inflation;" it even worked in the sixties, I think. And so the choice was made in the direction of stimulating the economy for understandable reasons.

Now that the inflationary psychology has gotten a hold on us and
ople anticipate more inflation, those choices no longer exist. We
n't have the choice of stimulating anymore, because if we took stimu-
ing action right now the financial markets would tighten, they
uldn't ease.

We have run out; we have been disillusioned about the nature of
ne of the so-called trade-offs. I think it's a combination of all these
nts and the attitudes that underlie the specific problems that you
htly point to. There is some kind of a common thread there. Pro-
ctivity hasn't been all that important to us; we give it a lot of lip-
vice, but when it came to a choice between doing something to sup-
t productivity and doing something else, we typically did the
mething else."

hope and I really think that what we are coming to understand is
t some of those choices have to be made in the other direction if we
really going to deal with this problem, not just in the next few
ths but over a period of time. That is the relevance, I think, of
e of the tax programs, some of the regulatory programs that we
ussed here this morning.

enator McGovern. Thank you very much, Mr. Volcker.

epresentative Reuss. Congresswoman Heckler.

epresentative Heckler. As you know, Mr. Volcker, there is a grow-
difference of opinion on what measures are entirely appropriate.
the one hand, there is a very loud voice from the electorate in
r of a balanced budget. On the other hand, from the business com-
ity relating to the question of increasing productivity, we have
owing chorus of demand for what is known on the Hill as 10–5–3,
ccelerated depreciation bill.

think I know what your answer would be in terms of priority.
etheless, in view of the problems of productivity, what is your
ng about 10–5–3 and about accelerated depreciation?

r. Volcker. I am not an expert on all the aspects of that bill, but
nk the depreciation approach is one valid approach toward deal-
vith this productivity problem. Whether it's 10–5–3 or some other
measures—all are useful areas of debate. I have sympathy toward
particular approach.

general, I think the approach of some direct stimulus and some
t incentive on the investment side is the correct way to go. That is
pproach that fits into that general framework.

presentative Heckler. You would like a business stimulus, but
ave been critical of other stimulative measures taken by the Con-
in anticipation of unemployment.

. Volcker. I say that's a way to go, as you implied in your ques-
I didn't say "Adopt it today." When we get the budget in shape,
would be, I think, a reasonable element in a tax package.

u can look at the investment tax credit; you can look at the way
x corporate income and all the rest. Those are alternatives. I
you have to sort out which way you want to go. There does
to be more of a consensus, I think, on the depreciation approach
perhaps on some of the others, but that remains to be tested. An
gent approach in that area makes sense to me. That doesn't
that's all you do. Individual tax rates are very high, too. You

want some kind of balance in the program. But I think that area is a very important element that needs more emphasis than it has had in the past.

In very general terms, on a matter of the tax structure that's existed for 30 years or more, we are not very kind, in my judgment, to the investment/savings process. Go back to the roots of our tax system; we tax income when it's earned and we tax it again when interest is earned on it. That tax really becomes a part of the capital when you are in an inflationary environment, and the interest rate is, in a sense, a way of keeping up with inflation. Looking at the other side, we allow deductions of interest payments from the tax bill.

The whole tax structure, I think, has been biased away from productivity, away from savings, away from investment, in favor of consumption; that bias, I think, ought to be changed. There is more than one technique for doing that. You mentioned one which has some promise. But when it comes to giving up revenues, let's wait until we turn the corner on the immediate problem.

Representative HECKLER. I would just like to get back to my basic question. Witnesses always enjoy generalized statements, and Members of Congress always like specific answers. The challenge lies in answering both, accommodating each without appearing not to respond.

But I am interested still in this question of where we are. I think the most basic question that any American has is what is happening in the economy. We all know the statistics. What is really happening. Now, in your elaboration and response, which was very extensive, and, I think, very invaluable to Senator McGovern's questions, you discussed some of the tensions which the Congress faces between the question of inflation and the prospect of a recession.

And my question to you—you have given the same basic answer but with a very important subtle difference, because I believe when I asked you earlier had the recession started, you said you saw no sign of that recession. Your answer today was you have seen no indicators of the recession. However, today, you said that you do expect a probability of a downturn.

I would like to ask you to define or expand on that probability. What kind of a downturn are you talking about, and when? And what is this economy actually saying in terms of the prospects in the next 6 months, year, et cetera?

Mr. VOLCKER. I know you like to pin me down to a very explicit forecast, but let me tell you that I think I would be doing you a disservice if I permitted myself to get pinned down too close, because the answer is that I don't know in specifics.

The major characteristic of this economy has been that it surprised everybody. To have me sit here and say, "My personal forecast is that industrial production is going to drop 2 percent in May," would be totally misleading. That's not my personal forecast, by the way. [Laughter.]

The point I want to make is that uncertainty is inherent in the situation that we face, and we would make a great mistake, in my judgment, if we said, "Look, we know we've got a terrible inflationary problem, but let's shy away from dealing with it, because my forecast—or

somebody else's forecast—is that the recession is not going to begin until the second quarter."

All I know is that what has happened is that that could have been said about any quarter in the past year, and it would have been wrong for four quarters in a row. The inflationary problem has gotten worse, meanwhile. We better deal with the problem that we know is here and that we know we're going to have next quarter as well as this quarter, which is the problem of inflation.

The economy has been surprisingly buoyant. It's got a lot of strength. Here we've got an economy that has two industries considered to be kind of bellwethers—housing and automobiles—which are weak, very weak. Yet the economy as a whole has held up. There's a great deal of strength in the whole investment area; we haven't had enough investment in the country, but relative to what we have been having recently it's very strong.

The automobile industry itself is doing an immense amount of investment. They cannot get their new small cars into production because they can't get delivery of machine tools and all the machinery that goes into the assembly line; all the suppliers are jammed up from here to kingdom come in terms of producing those kinds of goods.

The basic metal industries are doing well. The computer industry and all these newer industries have been doing surprisingly well in the face of strong recessionary tendencies in other industries.

All that has been going on for a year in a surprising way. I do think that the probabilities remain that we are going to have some kind of a downturn, recession, softening, before this year is over. It may come sooner rather than later. I just don't know. I do know that whatever that situation is, we better deal with this inflation problem.

I don't see the kind of obvious imbalances in the economy, for instance, on the inventory side, that have sometimes given us a very quick and sharp downturn in the past. I also note that we have a couple of industries already depressed, so there is a question of how much lower they can go. They may even be rising if the rest of the economy falls, which is also a factor that one would expect to limit the severity of any downturn.

Representative HECKLER. My time has expired, Congressman Reuss.

Representative REUSS. Thank you very much. The morning has now been consumed. We appreciate your helpfulness, wisdom, and cooperation. We now stand in adjournment.

[Whereupon, at 12:05 p.m., the committee adjourned, subject to the call of the Chair.]

[The following written questions and answers were subsequently supplied for the record:]

RESPONSE OF HON. PAUL A. VOLCKER TO WRITTEN QUESTIONS POSED BY SENATOR JAVITS

CONGRESS OF THE UNITED STATES,
JOINT ECONOMIC COMMITTEE,
Washington, D.C., March 26, 1980.

Hon. PAUL A. VOLCKER,
Chairman, Board of Governors,
Federal Reserve System, Washington, D.C.

DEAR MR. CHAIRMAN: Senator Jacob K. Javits has requested that the enclosed questions be sent to you. They, along with your answers, will be in-

cluded in the record of the Joint Economic Committee hearing on the President's new economic proposals, which was held on March 20.

We would appreciate your reply as soon as possible in order to insert the answers in the final transcript.

Thank you for your attention to this matter.

Sincerely,

JOHN M. ALBERTINE,
Executive Director.

Enclosure.

1. Why has the President's anti-inflation program not focused on the supply side of the economy? The President has indicated that we must first have a balanced budget before he would consider any further tax cuts. Would you interpret that to mean that the President is only committed to balancing the budget for one year? What would be the elements of a fiscal policy that would permit the Federal Reserve Board to begin to bring interest rates down?

2. What are your views on establishing a two-tier prime rate that would differentiate between large and small business? Is it not a fact that the small business community is the sector of the economy that will be the most hit by the coming credit crunch? What remedies would you propose to alleviate the effects of the credit restraint program on small business?

3. What do you expect the impact of the President's anti-inflation program will be on the value of the dollar in the foreign exchange markets? Do you believe that we are in the midst of an international interest rate war? Is there a trade-off between domestic and international factors in determining U.S. monetary policy? If a credit tightening should develop worldwide, what effect would this have on the oil importing developing countries and their ability to service their present debt burdens and to incur new debt?

—

BOARD OF GOVERNORS OF THE
FEDERAL RESERVE SYSTEM,
Washington, D.C., April 7, 1980.

Hon. JACOB K. JAVITS,
U.S. Senate,
Washington, D.C.

DEAR JACK: I am pleased to enclose responses to the questions you sent as a follow up to the hearings on March 20 on the President's new economic proposals.

Please let me know if I can be of further assistance.

Sincerely,

PAUL A. VOLCKER,
Chairman.

Enclosure.

Question 1. Why has the President's anti-inflation program not focused on the supply side of the economy? The President has indicated that we must first have a balanced budget before he would consider any further tax cuts. Would you interpret that to mean that the President is only committed to balancing the budget for one year? What would be the elements of a fiscal policy that would permit the Federal Reserve Board to begin to bring interest rates down?

Answer. There is no disputing that supply-side considerations are important—indeed, the President took specific note of this in announcing his anti-inflation program. The benefits of fiscal policy intitiatives in this area, in terms of relieving price pressures, are not likely to be realized quickly, however, and in the meantime such initiatives will add to the federal budget deficit. At this juncture, both to ease pressures on financial markets and to establish greater public confidence in the government's commitment to ending inflation, the most pressing need is to evidence the sort of commitment to fiscal restraint that would be entailed in establishing a balanced budget for fiscal year 1981.

Question 2. What are your views on establishing a two-tier prime rate that would differentiate between large and small business? Is it not a fact that the small business community is the sector of the economy that will be the most

hit by the coming credit crunch? What remedies would you propose to alleviate the effects of the credit restraint program on small business?

Answer. The degree of difficulty that businesses may encounter in coping with conditions of credit stringency is not a function solely of their size. However, smaller firms tend to have less access to some types of credit sources, and thus less flexibility in adjusting to a tightening of credit conditions. The Board has specifically recognized this in its voluntary credit restraint program by advising lenders to give special consideration to the needs of small business customers. Even prior to the introduction of the program last month, many banks had introduced special below prime base rates for smaller firms—such plans certainly are in the spirit of our current program.

Question 3. What do you expect the impact of the President's anti-inflation program will be on the value of the dollar in the foreign exchange markets? Do you believe that we are in the midst of an international interest rate war? Is there a trade-off between domestic and international factors in determining U.S. monetary policy? If a credit tightening should develop worldwide, what effect would this have on the oil importing developing countries and their ability to service their present debt burdens and to incur new debt?

Answer. Demand for the dollar in foreign exchange markets clearly is highly sensitive to the outlook for inflation in the United States. The dollar has shown considerable strength in the period since the President's announcement of the government's anti-inflation actions. This, I believe, demonstrates that, especially in the present circumstances, there is no real conflict—or trade-off, as you put it—between our domestic and international goals.

As regards the question of a possible interest rate war, it is possible that at times countries' views with respect to the exchange values of their currencies may conflict. Conceivably such a situation could lead to "competitive" interest-rate increases. I believe, however, that the dominant element in the general rise of nominal interest rates in the industrialized nations over the past year has been the need all countries have felt to come to grips with inflationary pressures by exercising monetary restraint. Communication among policymakers in the various countries is good, and I trust that the dangers of competitive appreciation are clear enough that any tendency in that direction would be quickly halted.

You are correct in highlighting the implications for non-oil developing nations of the OPEC price hikes as one problem that would be exacerbated by an excessive world-wide tightening of credit and/or a sharp downturn in industrial activity. The OPEC surplus will grow enormously this year, and both the industrialized and developing countries are likely to experience substantial deficits. The world financial system should be able to cope with this general situation, although some countries will no doubt encounter difficulties that will require adjustments in lending agreements or assistance from international agencies.

THE PRESIDENT'S NEW ANTI-INFLATION PROGRAM

THURSDAY, MARCH 27, 1980

CONGRESS OF THE UNITED STATES,
JOINT ECONOMIC COMMITTEE,
Washington, D.C.

The committee met, pursuant to notice, at 10 a.m., in room 5110, Dirksen Senate Office Building, Hon. Clarence J. Brown (member of the committee) presiding.

Present: Senators Roth and McClure; and Representatives Brown and Rousselot.

Also present: John M. Albertine, executive director; Kent H. Hughes, Keith B. Keener, and Mayanne Karmin, professional staff members; Betty Maddox, administrative assistant; Charles H. Bradford, minority counsel; and Stephen J. Entin, minority professional staff member.

OPENING STATEMENT OF REPRESENTATIVE BROWN, PRESIDING

Representative BROWN. Today is the third in our series of hearings on the President's new anti-inflation program. The President's latest anti-inflation program seems to be doomed to the same failure as his earlier programs. In response to the President's plan, the stock market continued to plunge downward. Expectations of higher inflation and higher interest rates have not abated and the bond market is suffering near catastrophic losses. Yesterday before this committee, we heard the latest bad news on the inflation front with consumer prices again rising at an annual rate of 18.2 percent a year.

The current situation stems directly from the indecisive and vacillating monetary and budget policies of the last few years. After excessive money creation in 1978, the dollar was down and inflation was up. Then policy flipped. Mr. Miller took a stab at slowing the money supply in November 1978, and the run on the dollar stopped. Then policy flopped, and we were off and running again with rapid money growth and more inflation in the summer of 1979. Then policy flipped again as Mr. Volcker took over to avert another market panic in October 1979. I hope this policy will not flop as well, either because of early abandonment on the one hand or excessive zeal on the other.

To make this necessary monetary restraint bearable and sustainable, the Fed desperately needs some help from Congress and the administration. The only credit controls should be on the Federal Government. The budget must be balanced and off-budget borrowing reduced to get the Government out of the credit markets. The limited credit being created must be left for the private sector. Otherwise, homebuilding, investment, employment, and real growth will collapse.

Credit controls on the private sector are not the answer. I am particularly worried about what additional restrictions on credit will mean for capital formation. The collapse of the bond market, the continued erosion of the stock market, high interest rates, and the voluntary guidelines for business loans will all make it more difficult for firms to obtain investment funds. In addition, the prospect of a recession is bound to dampen investment plans. The failure to save and invest in the midseventies is the fundamental reason for America's embarrassing performance in productivity and declining living standards.

To discuss these and other issues, we are very fortunate to have with us Mr. Arthur Burns, former Chairman of the Board of Governors of the Federal Reserve System and currently a resident scholar at the American Enterprise Institute. Mr. Burns is a man who mixes scholarship with wide-ranging practical experience. His advice is sought in every financial center of the world. He has been generous enough to appear before us this morning on short notice. I want to remind the members of the committee that we have promised to let Mr. Burns go by 11 a.m., and that we will operate under the 5-minute rule.

Mr. Burns, would you like to make a few initial comments, or shall we go right to questions?

STATEMENT OF ARTHUR F. BURNS, FORMER CHAIRMAN, BOARD OF GOVERNORS, FEDERAL RESERVE SYSTEM, AND CURRENTLY A RESIDENT SCHOLAR, AMERICAN ENTERPRISE INSTITUTE, WASHINGTON, D.C.

Mr. BURNS. Thank you very very much, Congressman Brown.

I perhaps will make a few comments; but I will not take long. I want to address the specific questions that you and your colleagues on the committee may have in mind.

The President, on Friday, March 14, addressed the Nation and presented his new anti-inflation program. That program consisted of five parts.

The President spoke of long-term structural changes.

Then he announced some revisions in the budget for fiscal year 1980, this fiscal year; and for fiscal year 1981.

The President informed the country of his plan to establish an oil import fee.

Fourth, the President announced certain revisions in the wage and price standards; and, fifth, the President informed the country that new credit restraint would be imposed by the Federal Reserve Board.

Let me make a few comments about the President's new anti-inflation program, as I see it.

First of all, the President failed to present a plan for stimulating improvements in productivity. The President failed to present a plan for dismantling regulations that have been impeding the competitive processes. The President failed to present a plan for modifying regulations concerned with health, safety, and the environment that have been running up costs and prices unnecessarily. In short, the President

uted nothing beyond some rhetoric to the structural policies
e needed for curbing inflation.
he budgetary front, the President made some marginal adjust-
but they are virtually confined to raising taxes, rather than
Government expenditures.
e is nothing in the new budgetary policy announced by the
nt to give people confidence that the long era of persistent
deficits is coming to an end.
e is nothing in the new budgetary policy to give people con-
that it will be more difficult to run budget deficits in the future.
e is little or nothing in the new budgetary policy that conveys
ity in a stable and frugal governmental financial policy.
e is, therefore, nothing in the new budgetary policy to turn
ary psychology around; to make people feel that inflation will
er be nourished in the future by excessive Government spend-

e energy front, the President's plan for an oil import fee is
tive; but instead of limiting inflation, the imposition of this
end to intensify it.
the wage and price guidelines, they have been quite ineffective
g inflation in the past, and I doubt that they will be any more
in the future; in fact, by explicitly raising the wage standard,
guidelines may have a perverse effect.
e extent that the new policy announced by the President can
fective in the fight against inflation, it will do so by extending
he monetary and credit restraints that were previously put
The essence of the President's newly proclaimed policy is
will continue to rely almost exclusively on monetary policy in
ts to curb inflation. That is far too great a burden to impose
deral Reserve.
rse, the critical question about the new, overall economic
nounced by the President is, "How well will it work?"
dgment of the financial community appears to be that the
has missed the opportunity to present a strong and credible
tion policy. The judgment of the financial community
o be that the President missed the opportunity to strengthen
e in our Nation's economic future.
ck market, the bond market, the money market have spoken
nce March 14. In each of these major financial markets, the
o the announcement of the new anti-inflation policy has been

l to do considerable traveling within the past 10 or 12 days;
ay I've had no opportunity to prepare a formal statement
tation to this committee. I've talked to many businessmen in
City, St. Louis, and Chicago, and I find members of the
ommunity feeling very discouraged at the present time. Let
t a few words about my own feeling.
ing is that nothing really constructive with regard to our
roblem has been accomplished by the President's new plan
l area.
e that the new policies for taxation and credit restraint are
into place at a time when our economy is already displaying
akness.

I regret to say that I am inclined to think that a recession has been hastened and perhaps will be intensified by the newly announced policy.

I am inclined to believe that the rate of inflation will be somewhat moderated in the course of the projected recession, but I also believe that the next economic recovery will start from a higher level of inflation than anything we have experienced in the past, unless our Government finally adopts and consistently stays with an economic policy that inspires confidence that inflation will come to an end and that economic productivity in our country will again flourish.

Thank you for the opportunity to make this brief opening statement. I am ready for your questions, Congressman Brown.

Representative BROWN. Mr. Burns, thank you very much. First, let me express our thanks for your appearing this morning. I also would like to express the apologies of the chairman of the Joint Economic Committee for not being present to hear your testimony this morning. I know he would have liked to have been here. He has asked me to preside.

I am sure the chairman, if he wishes, will write out some questions for your response. We would be happy to have you answer in writing. We will reserve that opportunity for him at this point in the record.

I would like to recognize the Senator from Delaware, Mr. Roth.

Senator ROTH. Thank you, Congressman Brown.

I find the mood of both the executive branch of government and the Congress one of willingness to work together to solve this problem. I think that this is needed at this time we seem to be facing now.

Would you care to comment on your feelings as to what the banking community will experience due to the President's initiatives that he released? I am also worried about the ability of a number of developing countries to service existing levels of debt. Are any of our major domestic banks overexposed or in any financial danger because of potential defaults on overseas loans?

Mr. BURNS. As to your first question, the cost of raising money will go up for the banks. So too will the burden of complying with the new regulations.

Turning to your second question, some of our banks have been rather careless in extending loans to less developed countries around the world.

I remember vividly what happened during the 1920's. At that time our investment bankers became enthusiastic about profits to be made by extending loans to foreign countries around the world; and they sent their salesmen traveling to encourage governments and foreign enterprises to borrow money.

The results of that experience are extremely instructive: The foreign loans that were extended in the early 1920's, along with the loans that were extended during the rest of the decade, were thoroughly tested during the Great Depression of the 1930's. The loans of the early 1920's, before the exuberance in lending reached a climax, turned out to be good loans; and practically all of the later loans had to be written off.

In the last few years our commercial bankers—either not knowing history, or ignoring it—have also sent salesmen around the world

encourage foreign governments and enterprises to borrow; and they
ve done so on a very generous scale.
By now, however, our bankers understand perfectly well, I think,
t they may have gone too far. They are cutting back on new loan
ensions; it is foreign bankers, bankers in Germany, Japan, and
er countries, that are now making loans to the LDC's on a very
ral scale.
think that some of the loans that have been extended to foreign
ernments and enterprises will never be repaid. However, our major
ks are still in a good and strong condition, and I think the banking
culties that you spoke of are, at this point, being exaggerated.
am inclined to believe that we will pull through, and perhaps
bankers will learn a lesson this time that they will remember for
w years.
enator ROTH. My time is up, but if I could just ask one short
owthrough question?
epresentative BROWN. Sure.
enator ROTH. With respect to housing, do you think that the Con-
s should do anything? For example, are you familiar with the
oks-Cranston legislation? If housing drops to, say, below the
illion new starts a year, is there any action we should take?
take it from what you say on banking, you don't see any par-
ar action necessary by the Congress. I wonder——
r. BURNS. I think there is one action that is imperative: To re-
l the Credit Control Act of 1969. That is a demagogic piece of
lation, one that has put dictatorial power into the hands of the
ral Reserve Board, a power that no agency of government should

passing this legislation, Congress abdicated its authority over fi-
al institutions. In the absence of new legislation Congress now
o power over any financial institution. All the power is now vested
Federal Reserve Board.
is is stupid legislation, demagogic legislation that is potentially
uctive of our economic system. The sooner we get that off
ooks, the better off will this country be; and I don't know any-
with higher priority for congressional attention than that.
presentative BROWN. Senator McClure.
ator MCCLURE. Mr. Burns, thank you for your opening state-
Thank you for the advice you have been giving to the Congress
e last many years. We would be in much better shape today had
en heeding some of that advice and acting upon some of the calls
tion, such as the one you just issued, with respect to the Credit
ol Act.
are seeing a severe depression already in the housing industry.
ers have been laid off—the layoffs started 2 months ago. The
urn is very evident, as the people who depend upon that for
ivelihood are already feeling that very real depression.
hin the last 3 weeks, nearly 50 building contractors have filed
nkruptcy in the Boise area alone.
last quarter reports of the savings and loan industry indicate
any of them were in a profit position only because of the pen-
for early withdrawals on deposits. I am sure the first quarter is

going to show many of them in a deficit position, with many of them not having the liquidity necessary to ride out any prolonged period of time.

If we look just at that one industry from the production of the products that go into the housing and through the building—all of the building trades, the lathers, plasterers, the plumbers, the electricians, the carpenters, the cement finishers, on through to the other end of the spectrum, the financial institutions which support that industry, the beginning of the depression is very real.

In the face of that, we are all being confronted with demands that the Federal Government "do something," and there will be efforts made, I am certain, to expand Government financing for housing by somewhere on the order of $2 billion to $6 billion.

That's a very tough appeal to resist when so many thousands of people are being directly affected in their jobs and livelihood. I mention that only because I am convinced in my own mind that we are not going to get to a balanced budget; that we lack the political courage to do what is necessary; and that the little efforts, the marginal efforts to cut spending are being much overshadowed by the increased taxation that is being proposed to balance the budget.

That increased taxation, piled on the lack of productivity in our society already, is going to plunge the Nation into a vicious downward spiral of efforts to balance the budget by raising the taxes, killing off the ability of industry to continue to function and, therefore, reducing receipts to the Federal Government.

There is no way that Congress can reduce expenditures at the margin rapidly enough to offset the downturn in revenues and the massive increase in unemployment compensation and welfare payments that will be required on the other side.

It seems to me that, if I am correct, what the country needs badly now is a policy geared to reducing the deficit, geared to reducing the Federal expenditures, geared to reducing the burden of taxation; or, to put it conversely, geared to increasing productivity in our economy.

Would you care to comment?

Mr. BURNS. Senator, you have focused on the homebuilding industry. I understand the problems of that industry. I have been a student of it for 50 years.

My advice to the Congress is not to try to patch up what now appears to be wrong with that industry. That won't work.

The critical problem of that industry is simply the very high level of interest rates. They have been soaring; and don't blame the Federal Reserve for it. Blame the Congress and the administration which have put the entire burden of fighting inflation on the Federal Reserve.

When the President's budget message and his economic report came out toward the end of January, financial markets responded immediately in ways that spelled disaster for the homebuilding industry. Interest rates soared once again.

Why? Because market participants reached the conclusion that the rate of inflation is likely to be a good deal higher than they had anticipated. As you well know, an inflation premium is built into interest rates, particularly long-term interest rates. Long-term interest rates rose promptly and sharply by some 2 to 3 percentage points;

mortgages, to the extent that there are any, are being contracted
at interest rates of 14, 15, 16, and 17 percent.
he way to solve the problem of the homebuilding industry is to
ion inflationary psychology in our country, to make people feel
inflation can be and soon will be brought to an end.
that happens, long-term interest rates would drop, and drop
ply. Mortgage financing would be revived; and the homebuilding
stry would before long be on its feet again.
hat is the only solution, in my judgment, that has any chance of
ling anything like permanent success.
nator McCLURE. Thank you very much, Mr. Burns.
ow much of inflation is caused by imported oil pricing? There are
at many Members of Congress pointing to the OPEC cartel and
ng to put the blame on both OPEC and the oil companies, which
ard as an effort to shift the attention away from the focus on the
ress.
rtainly oil prices had some impact upon inflation.
. BURNS. There is no question about that. I don't think I can
you a precise figure, but I would point out that there are other
ries in the world, notably Germany, Switzerland, and Japan,
import far more oil, practically all of their oil; and the rate of
ion in those countries, while it has been rising of late, is in the
borhood of 6 percent, which is less than half the inflation rate
ve recently have been experiencing.
t is an indirect answer to your question. As for numbers, I
guess that perhaps 2 percent of our inflation rate, possible a
nore could be attributed to the oil price.
ator McCLURE. 2 percent, or 2 percentage points?
BURNS. 2 percentage points, thank you. But I regret to add
demagogic theory of inflation has developed—namely, that
and our oil companies are responsible.
hardly a friend of OPEC. I wish some of the policies I advo-
back in 1973, when the price of oil was quadrupled, had been
d. But I must also say this; that in part, the increase in the
f oil by OPEC is due to the sharp rate of inflation in this
y and in many others around the world. OPEC is not only
g inflation; it is also responding to inflation elsewhere.
ou must know, blaming OPEC for our inflation has become a
e political exercise. It has almost become the official adminis-
's theory of inflation.
lleague of mine went through an interesting exercise. He told
in reading the report of the Council of Economic Advisers, he
ome 81 or 91 references to OPEC as being responsible for the
n.
her and new administration theory of inflation was, however,
by the President's invoking of the Credit Control Act of
hat act can be invoked only when the President determines
cessive creation of credit is causing or threatening to cause
n. So this is a new theory of inflation.
while I have very little sympathy, as I have indicated, with
e President did under that act, while I think that act is danger-
the country, and while the new theory of inflation is also im-

perfect, it's much sounder than the oil price theory which has been shouted from every political stump in this country.

Representative BROWN. Congressman Rousselot of California.

Representative ROUSSELOT. I guess I still think of you as Chairman of the Federal Reserve Board. We are delighted to have you, Mr. Burns.

I want to compliment you on your very strong and forthright statement about the necessity to repeal the 1969 act. It is dictatorial. The powers that we passed on to the Federal Reserve Board were clearly dictatorial, with the ability of the President to—as you say—throw the ball to the Federal Reserve Board.

Now some of our great politicians in this Congress are yakking and screaming and shouting that they are doing it wrong over there at the Fed. However, they are the very ones that voted to give them all those powers. Now they are disagreeing with the way the Fed is using them.

Mr. BURNS. Why don't you ask them to join you in getting rid of it?

Representative ROUSSELOT. To repeal it?

Mr. BURNS. Right.

Representative ROUSSELOT. I tried to do that the other day. My colleague from Wisconsin, Congressman Reuss, was a little discomfitted. He was one of those that voted to give the powers to the Fed.

Maybe we should put in a bill to repeal it. Some of us have felt for a long time that they held dictatorial powers. They are unwarranted and incredibly strong.

Mr. Volcker was before our committee last week; and I questioned him on the subject of tax reduction, because I knew that he was one of those who believed in the Kennedy tax cuts of 1963 and 1964. And I acknowledged to him that that was a different time and place.

But aren't the principles of tax reduction also necessary in this budget mix that we are discussing now for 1981? If we don't have some kind of tax reduction—especially in rates—the burden of this budget for 1981 will be carried on the backs of the taxpayers of America— even if the Congress imposes no new taxes. Evidently that's what the President wants, because it's very much a part of his budget—$92 billion worth of revenue increases, if the Congress does nothing, in the proposal being offered by President Carter.

Now, do you agree that part of the budget package should be some kind of tax relief to appropriately reduce the tax bias against saving and investment, and that that should be absolutely an essential part of our budget process?

Mr. BURNS. I think we have to be cautious. The economic and financial environment of today differs very much from that which existed in 1964 when the Revenue Act of 1964——

Representative ROUSSELOT. I acknowledge that.

Mr. BURNS [continuing]. Under which massive tax reductions were made, was passed.

Representative ROUSSELOT. I acknowledge that.

Mr. BURNS. The major difference is we had between 1958 and 1964 an absolutely steady wholesale price level and a consumer price level rising by something like 1 percent a year. In effect, we had price stability during that period.

As for your question, I made a suggestion on tax policy as a part of anti-inflation program when I testified before the Senate Banking mmittee on March 14.

I testified in the morning. I could not testify at that time on the esident's anti-inflation package, which was formally announced in afternoon, even though most of that package had been earlier closed in the press.

Let me read from the testimony that I gave. This is a part of a gram designed to turn inflationary psychology around, which I nk is our critical problem.

y suggestion calls for legislation scheduling reductions in business taxes in of the next 5 to 7 years—the reduction to be quite small in the first 2 years to become substantial in later years. This sort of tax legislation would not up the budget deficit in this critical year or next; it would thus scrupulously d fanning the fires of inflation. Its passage would, however, release powerful es to expand capital investment, thereby improving the Nation's productivity exerting downward pressure on prices later on.

epresentative ROUSSELOT. Would that be similar to the 10–5–3 bill have before the Ways and Means Committee in the House? I think as been introduced in the Senate, too. That's the bill to modernize depreciation schedule—the Conable-Jones Act.

r. BURNS. I would have to study that closely before I could ment on it. My recollection is that the bill provides for the revised reciation rules to become effective immediately. I think you could se them in gently so that the impact on the budget would be small year and the next year, but would then step up.

nator MCCLURE. Would you yield on that?

epresentative ROUSSELOT. I want to follow up on that. Then I will l.

ou see, that would help the automobile industry, the steel industry, housing industry in many, many ways. That would be less tionary, as you have said, as to its impact on the budget, because would be a reflow—projected—to the Treasury because of nded plant creation, manufacturing equipment creation, job ion; and I guess that's what you had in mind.

. BURNS. Yes, entirely.

presentative ROUSSELOT. I now yield to my colleague.

nator MCCLURE. I was going to ask how about a tax reduction dule that had almost no reduction in the first 2 years, but had r reductions in the third, fourth, and fifth years.

. BURNS. That would fit my prescription ideally.

presentative ROUSSELOTT. One more quick question.

colleague here, Congressman Brown from Ohio, has duced—and many of us have cosponsored—legislation to blish incentives for savings in a gradual way, to encourage thrift, specially to be helpful to financial institutions that try to attract kind of savings.

ou are not prepared to comment on that today, I wonder if that sed legislation might fit in your package that you have just bed? You may want to respond further in writing.

BURNS. All that I can say today is that I find Clarence Brown's stion fascinating. It's new. I have not studied it. My initial on is favorable. I think it's highly important to have an objective of that proposal made promptly.

Representative ROUSSELOT. To the best of your ability to comment back in writing, it would be helpful. We are thinking of offering it in the House as part of a tax incentive package, to do the very thing you described. So your response would be helpful, if you could, within the next week.

Mr. BURNS. I doubt—I can't promise you that.

Representative ROUSSELOT. Well, the best you can.

Thank you. Congressman Brown.

Representative BROWN. When Mr. Volcker testified last week on the need to curb Federal spending, I had the following discussion with him. I will summarize briefly. I asked him, "Would ending Federal deficits and Federal borrowing make slower money and credit growth easier to bear and stick with?"

His response was "Yes."

"Do you view fiscal restraint as supportive of a policy of controlling money and credit growth, or a substitute for it?"

Mr. Volcker responded, "Supportive. We will maintain restraint to the extent we reasonably can over the growth of money and credit. That process is facilitated by restraint on the budgetary side. It will enable us to achieve that with less effects in the credit markets, less strains and tensions. But it's not a substitute for restraint on money and credit growth."

Would you care to comment on that?

Mr. BURNS. I think that's an excellent statement. I would agree with it.

Representative BROWN. So apparently we may by that have a little view of the byplay that went on in the administration over current policies, because I gather that that infers some agreement with your view on the part of Mr. Volcker about the whole question of use of the Credit Control Act and the fact that we must have budgetary or fiscal restraint in order to make the monetary restraint that he's trying to exercise on the Federal Reserve Board sensible.

Let me go on from there to speak to your suggestion about the reduction in taxes over the next 5 or 7 years, with a lower reduction now and more later.

You said that would release powerful forces for the underlying expansion and modernization and improvement of the competitive nature of the American economy: but it occurs to me that it will not release those forces unless, in fact, we had a credit situation where those people who wanted to expand their operation could move into credit markets, get the credit to finance the early steps of that expansion, and see us go ahead and develop; so that the freeing of those credit markets is fairly essential to the expansion of those credit markets: is it not?

Mr. BURNS. If the sort of tax plan that I suggested were legislated by the Congress, the demands on the credit market would not be increased appreciably within the next year or so. They would come later on.

With the Federal budget under control, there would be ample room for financing a much larger volume of capital formation in our country.

Representative BROWN. But the key is getting the Federal budget under control to the extent that it's not forcing out—that is the Fed-

eral deficit—other creditors, private creditors who need to borrow the money. Is that essentially the underlying——

Mr. BURNS. I would say so, but I also think the debates that have been going on in the Congress, and that have been keeping members of the press so very busy, don't really amount to anything.

We are talking about very marginal adjustments. Consider what the President proposed on March 14 for fiscal year 1980. Expenditures would be cut, in some unspecified way, by $2 billion. Simultaneously, other expenditures would be raised in some unspecified way by $6 billion. Therefore, there would be a net increase in spending in this fiscal year of $4 billion.

For fiscal year 1981, the President proposed that expenditure cuts of some $13 to $14 billion would be made. He listed specific cuts totaling $3.1 billion. He left the rest to be specified at the end of the month.

At the same time, the President indicated that expenditure increases of some $9 to $10 billion would be made; so there would be a net decrease of some $3 to $5 billion in fiscal year 1981.

In short, expenditures would go up by $4 billion in this fiscal year, and they would go down by $4 billion in the next fiscal year. Why are we wasting our time and energy on such minute manipulation? Hasn't God given us brains? Why aren't we using them?

Our fundamental problem really is not even the deficit this year or next.

Our problem is to look ahead and to create a legislative environment in which it will be much more difficult to run budget deficits year in and year out. If the Congress did that, I can assure you that we would have a revival of confidence in our country, and we could have a renaissance of our economy.

Why are we wasting our energy in talking about these miniscule changes here and there? What the Congress ought to be doing is to make it much more difficult to run budget deficits in the future.

Representative BROWN. I gather your feeling is that messing around with $4 billion plus, or $4 billion minus in the budget which is in excess of $600 billion; that it is something less than courageous?

Mr. BURNS. Obviously it isn't courageous. It's even ridiculous.

Why are sensible men like yourselves doing that? I sit back and scratch my head. There's so much high intelligence in the Congress. But Congress is not showing it in the fiscal area.

Representative BROWN. I'm not sure how I should respond to that as the temporary chairman of this committee, Mr. Burns. [Laughter.]

Mr. Burns, let me ask just a final question, if I may. Then I will let Senator McClure close off the hour that you had to spend with us.

This is about the competitive nature of the American economy in the world. We have declining productivity, negative productivity growth at this point; and we are finding, to an increasing degree, that foreign producers are taking over not only many foreign markets where the United States was in recent years dominant, but also many markets in the United States: steel, automobiles, electronics, a wide variety of others.

It has generally been conceded that one of the problems is the lack of modernization and competitiveness of the American industrial plant.

Others have alluded to the decline in productivity of the American worker. Although it's unclear to me whether that's a result of the plant deterioration, or whether it's the result of some impact in the American spirit.

Would you comment on that for us and suggest to us the guide to get us out of that problem?

This committee, as you know, has recommended for current policy during its report last year, which was unanimous, and its report this year, which was unanimous, that we have a steady as you go monetary policy; that is, that due restraints be applied to monetary policy of the country to reduce or at least contain the money supply.

And that we have tax cuts underlying both savings and investment, and capital plant expansion and modernization, and that we have a balanced budget, or move toward restraint in the fiscal sense to try to squeeze inflation out of the system on that basis; and as I said, a tax cut to stimulate the supply side of the economy to get America growing and moving again, so that we can look forward to the day when products each year cost less rather than more, because we are finding more efficient ways to produce them.

Would you comment both on that policy from this committee, the policy recommendation from this committee, and also on the long-range needs of our society?

Then I will let Senator McClure ask you a final question.

Mr. BURNS. As you know, Congressman Brown, productivity in our country has been languishing since the midsixties. The historic rate of increase apparently has come to an end. Last year, output per man-hour in the Nation actually declined.

I think it's highly important to improve our productivity once again; and I think that modernizing our industrial plant, much of which has become obsolete, is one of the most important things we can do to achieve that.

I think that this committee is deserving of great credit for recognizing the problem.

I think this committee deserves commendation for working in a bipartisan spirit.

The last time that I recall a report in which the minority and the majority were entirely together was in either 1953 or 1954—a long time ago.

So I think this committee is working along sound directions. The problem is, of course, that not enough of your colleagues listen to this committee.

But I do want to express a word of warning. I often hear that improvement of productivity is the answer to our inflation problem. It is not an answer to our inflation problem. It is, however, a limited answer to our inflation problem, and we ought to make use of that limited answer.

But let me now make a very extravagant assumption—and I don't know of any economist in the country who would consider it realistic—namely, that we go back to the historical rate of improvement of 3 percent per year. In that event, an inflation rate of 18 percent would come down to 15 percent. Or if the inflation rate is 13 percent, as last year, it would come down to 10 percent.

That's worth doing, obviously, but it's not a solution to the inflation roblem.

Productivity improvement is important to our country not only ecause it will help to a degree in the fight against inflation. It's espe- ally important, I think tremendously important, in making the merican people feel that our economy is growing, that the national ie is becoming larger, that each of us in our industry or region can are in the increase.

Unless our productivity improves, any lifting in the standard of ving of one group, one industry, one region of the country, will be the expense of another group, another industry, another region of e country.

This will create social tensions in our country. This will create hos- ity, a sense of frustration, a sense of bitterness. To maintain social bility, to maintain political stability, improvements in productiv- have become essential. I would stress that even more than the con- ibution that improvements in productivity can make to curbing flation.

Senator McCLURE. Mr. Burns, your statements this morning have en very forthright and very direct. I know that I share with the ier members of the committee the appreciation for that at a time t is so critical to our country.

I don't think, as a more than casual student of history of this coun- , that we have faced more awesome challenges at a single period our time than we do right now. The military threats, the foreign eat of aggression against our country, the energy problems that front our country, and the inability of Congress to cope with that; bility because they won't or because they misunderstand; and the nomic crisis that now confronts our country and that now occupies nt pages.

ll coincide in time. They are not totally unrelated, and neither are solutions unrelated.

look at what has happened over the last few years and see the great leration of the increase of the problems, the decline of our ability eal with those problems. It took us nearly 175 years in this country each the point of $100 billion in revenues.

Ir. BURNS. Yes. Fiscal year 1962.

enator McCLURE. Yet, we are now going to increase revenues by tion—by increases in taxation of $100 billion in 1 year.

Ir. BURNS. A little over $100 billion.

enator McCLURE. It took us only 8 more years, after the first 175 s, to reach the $200 billion.

fter having reached $200 billion, it only took us 4 years to reach billion.

r. BURNS. In 1975.

enator McCLURE. It only took us 3 years to reach $400 billion.

r. BURNS. Another 2 years. In 1977.

nator McCLURE. The same thing with reaching the next $100 bil- increase. Now we are doing it on an annual basis, or less.

, indeed, the rate of change is as threatening as the amounts them- s; and I agree with you totally that we will not solve the prob- until we have changed the underlying attitudes of the people of

this country in terms of their confidence that we will solve these problems.

That's why it seems to me that we must make extreme efforts this year, now, immediately, to reduce expenditures, to limit spending rather than increasing taxes, to encourage investment and saving. If we do not do those things now, we will see the rate of change upward in taxes and prices increase, and then the rate of change downward in productivity increase; and then that spiral that so many people talk about in escalation of prices and wages will suddenly turn into a deflationary spiral as the economy collapses.

That is something that I don't think we can overestimate. I don't know of a period in history when I have been more frustrated with the complexity and the difficulty of the problems, with the solutions obviously in sight, and the political institutions unable or unwilling to respond.

We have men and women in the Congress who have made a career out of promising people things that we as a nation have not been able to avoid. Who have made a career out of refusing to face reality. Who have made a successful political career out of the demagogic appeals of "let's soak big business and let's help the poor."

I took a little heart yesterday in the President's speech to a Democratic group in which he said, "I am going to approach these problems with love, concern, and compassion," because that probably means he's going to do exactly the opposite.

If, as a matter of fact, he's willing now to confront the basic political fabric that has sustained his party for the last several years by doing some of the hard things that fly in the face of demagogic rhetoric, we may find a cooperative Congress also doing things that have to be done if the poor are to have a chance to live with dignity, if the minorities are to have a chance to grow with our society, if the young people are able to look forward with confidence to a free political and social institution in this country.

Your comments this morning have been particularly on target, it seems to me. I just hope that there are many dozens of Members of Congress that will listen; but I have learned to believe that for a great many of them, they will listen most if the people back home tell them they better. For most of them, they will respond only when they get that clear message which you have given repeated to them by the people that vote for them or against them back home.

Thank you very much for your statements this morning.

Representative BROWN. Mr. Burns, thank you for being with us. As with most things Congress does, we are a little over our budget by about 5 minutes. We promised you 11 o'clock. We do appreciate your sharing your experience with us today.

Mr. BURNS. Thank you very much, Congressman Brown.

[Whereupon, at 11:05 a.m., the committee adjourned, subject to the call of the Chair.]

[The following written testimony was subsequently supplied for the record:]

PUBLIC POLICY AND THE ECONOMIC OUTLOOK

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Testimony Before The
Joint Economic Committee, Washington, D.C.
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PUBLIC POLICY AND THE ECONOMIC OUTLOOK

I appear before you today as a practicing business economist who happens to sit on the Investment Policy Committee of a medium-sized counselling firm, who serves as a senior economic adviser to a medium-sized Federal Reserve member bank, and finally, as one who also teaches public policy to graduate students of business at an urban university. I note this background to distinguish myself from those who advise you from the perspective of partisan politics or ideology, whether old fashioned or new fashioned, and from those who accept the mantle of witch doctor with magic formulas that are bound to work in a troubled economic world. In a word, I advertise myself as a pragmatic economist who has been around the track a number of times and who has a life-long interest in the business cycle and public policy.

My views about the economic outlook over the past eighteen months have had some notoriety because I have argued publicly, some would say vociferously, that the U.S. economy was not heading into a recession. I took that position following the November 1, 1978 moves to bolster the dollar. I reiterated it last summer at a time when almost the entire profession in and out of Washington was mesmerized by the sharp drop in the economy that took place. Alas, my colleagues preferred to ignore the simple statistics reported by the Commerce Department which showed that the second quarter, 1979, economic dip was entirely the consequence of what can be summarized as gasoline lines, including, interestingly enough, a sharp drop in restaurant sales. In hindsight, it was obvious that consumers who could not buy gasoline to get to work and, therefore, refrained from buying new cars or personal trucks would also not be in a position to take the family car to the local restaurant. I continued to take the positive position after the October 6 moves by the Federal Reserve Board.

Why was I so stubbborn throughout last year in taking such a contrary, anti-consensus position? Basically, my position was based on three main postulates. (1) Consumer spending was tied closely to real incomes as consumers tried to cope with an unprecented inflation rate. Why should they, I argued, refrain from spending under these circumstances? (2) Business executives have taken a cautious and conservative posture on inventories, and they have remained cautious to this very day. They were mindful, I argued strongly, of the 1974-75 recession when inventories were built up excessively at a time of misconceived shortages and these bloated stocks turned into a disaster. (3) Perhaps most important of all, business plans for capital spending were strong throughout the period. The various surveys of capital spending plans were misread and misinterpreted on the part of Cabinet officials and leading business economists. They fully expected capital spending to poop out at every point during the year including the end of the year. History now shows how wrong these perceptions were.

There are two key points about this strength in capital spending I want to emphasize. I have a stake in this capital spending forecast since whatever reputation as an economic forecaster I have built up over

the decades has been centered in capital spending, and I am naturally proud of the fact that I fathered the capital appropriations survey more than two decades ago. These points relate to the outlook for 1980. It is clear that the biggest push by capital spending is coming from the burst in spending on the part of the oil industry. Once the public policy decision was made to open up financial incentives for new energy finds it was easy to forecast what would happen. I was not at all surprised a month ago when the oil industry's capital budgets were reported to be up some 30% for 1980 to a total of $50 billion. I need not remind you that these budgets are largely self-financed. The oil industry has the money to invest, has the incentive to invest and is in fact investing. It is something which our entire society should welcome and I welcome it. Naturally, I am delighted about what they have been finding in recent months. I hope that further successful finds are on the horizon.

The second major point I want to make about capital spending is the substantial rise in manufacturers' capital appropriations reported in the fourth quarter of 1979, including further and substantial increases in backlogs, as well as the counterpart of new project starts reported by the Commerce Department along with increases in carryovers of unspent funds. All this took place at a time when interest rates soared and recession forecasts dominated the landscape. There can be no question that the strength in capital goods is real and it shows no signs of abating.

Today, I am asked, how can you continue to hold the no-recession position when the profession almost unanimously argues to the contrary, placing the heaviest burden of their argument as they have throughout the past eighteen months, on Federal Reserve Board actions and the resulting sky-high interest rates? First, I argue against the recession forecast since in so many instances it really represents a wish rather than a forecast. I do not want to be associated with such an argument. Indeed, some distinguished Wall Street economists state their preference for a recession quite openly and bluntly. Such recession pessimists say that the only way the allegedly accelerating inflation rate can be slowed down at all is a recession and a few would even say the bigger the recession the better to accomplish this goal. I reject such counsels of despair as counter-productive. While I would not deny that some deceleration in the inflation rate might result from a recession, I would hasten to emphasize that such a respite would be temporary. The pressure to reflate would be enormous and the bigger the recession the greater the pressures. A mild recession might temporarily downplay inflation as an issue in the election year debate or more probably dampen the concern, but inflation would reappear with a vengeance in 1981. A recession is not the answer to the problem. Economists who argue for a recession as a cure, and even accept it as a temporary cure, are taking a short-sighted view and are looking for panaceas to combat a deep rooted problem.

Second, I continue to argue for a no recession outlook in 1980 just as I did in 1979 because there has been added to the impetus in capital

goods a new source of economic strength which complements and adds to the force of private investment, namely, the coming rise in national defense spending. A year ago, to be sure, the President's budget called for a 3% rise in real defense spending, but instead we got less than 1%. Today, I believe, circumstances are different. The pressures are a lot greater so that the realization of a substantial rise in real defense spending has a high order of probability. Moreover, the rise in spending is no longer a one shot affair, but rather part of a coherent plan that runs for at least the next five years. Those observers who play down the economic significance of the renewed upward slope in defense outlays are making a major mistake. The economic impact of more defense is coming not from more personnel, but rather it is concentrated in procurement and research and development, and these should at some point synergize with private capital investment.

Public policy, to be sure, has not been neutral in recent months. What do the latest moves by the President to cut the budget and by the Federal Reserve Board to calm down the money market mean? My response to these questions now before this Committee had to be prefaced by an explanation of my prior forecasts and my current forecast. Now to answer these questions I have to trace recent major events. Oversimplified, the new national defense outlook guaranteed that the inflation would not decelerate at all this year. As a result, the bond markets in January readjusted almost instantly to this new state of affairs by plunging despite the fact that they had already plunged in October. The damage done to inflationary expectations was too great. Given a new perception that a 10% inflation rate was the floor, bond rates according to the widely accepted conventional wisdom had to become at least 13% to allow a real rate of return to the lenders over and above the now expected long-term inflation rate. The distraught money markets were not helped at all by the huge inflation numbers posted by the Consumer Price Index and the Producer Price Index for January, which were reported in February. On top of this, the money markets became hysterical about the President's budget message which even those who ordinarily could be expected to be sympathetic called fiscally irresponsible. The money markets in February acted on that premise. Leading financial market spokesmen raised their voices in a chorus of doom, none of which helped to calm down the hysterical money markets. All this explains why the President, rightly in my view, had to state publicly and vehemently that in effect his 1981 budget proposed in January was a mistake. I think that the serious promise to balance the budget made in March, while late, is nonetheless highly significant. President Carter is the first chief executive since Eisenhower to make such a promise. Despite contrary statements on the part of some economists, I hold strongly to the view that the revised budget represents an essential ingredient of policy which should help to restore sanity to our financial markets.

As for the recourse to the Credit Control Act of 1969, I must remind this audience that in the March 19, 1979 issue of Business Week, I was quoted as follows. "If circumstances warrant, the President can invoke the law suddenly on a quiet weekend." Each President does things

his own way, so I was wrong about a quiet weekend, but surely circumstances warrant the invoking of this law. I have to state publicly what few are prepared to say out loud. The United States has entered a new and uncharted era of credit controls. I know that it is all supposed to be voluntary. Let me cite, however, first hand knowledge of one medium-sized bank which received the detailed regulations at 9:00 A.M. from its distinguished outside legal counsel on the day following the weekend of decision and acted as if it were legally mandated. I view consumer credit controls as cosmetic. It is important since it is a noble attempt by the government to impress the citizenry that it is serious about the role of credit in an inflationary economy. There is no way that the ordinary citizen can be expected to understand the intricacies of managed bank liabilities but they do know about American Express, Master and Visa cards. With my particular emphasis on the voluntary credit controls, I fully expect that the Federal Reserve authorities will be able to implement its policy on the large commercial banks, the announced target of the new program. I take it for granted that the Fed will now accomplish its objectives of controlling the monetary aggregates. What should happen is now happening. The price of gold and silver is down, world commodity prices have plunged, and the dollar has strengthened remarkably, itself an anti-inflation consequence of some importance. I take at face value the assurances by the Federal Reserve Board that financing for productive purposes will be forthcoming, and that small business and agriculture will get special dispensation. I would expect that one way business will minimize the effect of high interest rates will be to minimize inventory building, even if it means risking the loss of some sales.

In view of all these developments and prospects, what then, is the state of public policy today? In my view, we are doing all we can do. To be sure, we might do some things better, and I may want to comment on that point in a moment. There is now in place a reinforced incomes policy. I am counting heavily on that unique resource called Professor John Dunlop to play a critically important role on the wages side. I am also pleased that the program has been corrected to secure the formal cooperation and involvement of organized labor. A viable voluntary controls program must have at its foundation the willing participation of those whose decisions are being affected. Second, the government has instituted a voluntary credit control program under the authority of the Credit Control Act of 1969, which, I must emphasize, can at any time be converted into formal and mandatory controls, a recourse which I along with Fed Chairman Volcker would view with horror. Third, the President has reversed a budget less than two months after it was submitted, an unprecedented event in U.S. fiscal history. In my view, all this should work to restore sanity to the money markets. I must note in passing that critics of the budget cutting proposals say what do you accomplish doing that. Well, there is now a textbook example of what can happen with a budget that is in substantial deficit. The Treasury's financial requirements for the last two weeks in March and early April came to a staggering $40 billion, and dealt a heavy blow to the equity markets and more importantly to the debt markets precisely at a time when it was hoped that some calm would return. I argue strongly that this foretells what could happen in coming months in case the Congress falters in its necessary duty in responding to the President's call for a balanced

budget. Indeed, Congress would be doing the country a great service by exceeding the President's budget cut requests. I need not remind you that there is a great skepticism in the financial community about the willingness of Washington in an election year to accomplish this difficult task.

I continue to be hopeful about all this, arguing that even if late, the various sectors of the decision making process are proceeding along lines that will help to solve the problem. On balance, then, I remain cautiously optimistic about the future growth path of the U.S. economy this year and remain convinced that it will once again be 2% as it was in 1979. Alas, even with all the pain that is yet to come, the inflation rate will still remain at around 10%. I would go on to predict that this slow growth can be expected in future years and it will take a great deal of doing just to get the inflation rate to budge downward a little. The basic argument for a no-recession economy comes from capital goods and national defense. This means that other sectors, including government and consumers, have to be restrained. Given the expected lackluster performance in consumer markets, for capital goods to continue on its needed upward path there may well have to be further incentives. The country must have increased productive facilities if only to provide the base for the critically important major rise in national defense. Productivity improvement and much greater research and development outlays are both necessary if we are ever to get the inflation rate to edge downward. I argue strongly that important incentives for capital formation are needed in coming years just to prevent the inflation rate from accelerating. We may need additional measures to help bring the inflation rate down appreciably below the 10% range now in place. I urge you, however, to do one thing at a time. Today, the most important thing is to restore some sense of stability to the money markets and that requires a wrenching cut in the civilian budget. If that is accomplished and the money markets calm down, mortgage rates should begin to stabilize and even retreat from their frighteningly high current levels. As you know, home prices are no longer soaring, the government's index of new home construction costs is going up a lot less than it did only a few months ago, and soon oil price increases will be going up at a 15% annual rate, not the roughly 90% rate of January and February. We simply cannot solve all our problems simultaneously. The latest moves by the Federal Reserve and by the executive and hopefully the Congressional branches should, in my view, help to solve the most pressing ones. I urge you to get on with the job.

CURRENT ECONOMIC POLICIES

TESTIMONY TO THE JOINT ECONOMIC COMMITTEE OF THE CONGRESS
BY DR. WILLIAM C. FREUND, SENIOR VICE PRESIDENT AND
CHIEF ECONOMIST, THE NEW YORK STOCK EXCHANGE,
AND PROFESSOR OF ECONOMICS, GRADUATE SCHOOL
OF BUSINESS, PACE UNIVERSITY, NEW YORK CITY, APRIL 2, 1980

I am honored to appear before this Committee whose members and staff have been in the forefront of developing sounder economic policies for our nation.

Short-Run Policies

With inflation running at 15-20% per annum, and likely to remain in that range for some months to come, it is high time, indeed late, to face up to the fact that we must find a way to halt runaway inflation. Given present rates of inflation, a gradual and relatively painless unwinding of inflation--or as economists like to say, a "soft landing"--is no longer an option. We face two choices:

Scenario One:

- We fail to act decisively, and employ only rhetoric and symbols. The result: a further speed-up of inflation as consumers, business and even governments anticipate further price increases. Contracts increasingly become indexed to the cost of living. For a while, we bask in the delusion of a new inflationary prosperity. But after a stiff escalation in prices, the inflation-prosperity breaks down and triggers a deep, prolonged economic downturn. The destruction of viable financial markets would be the least of the economic and social costs society would have to bear if this scenario becomes reality.

Scenario Two:

- We act decisively now to avoid the further serious and prolonged damage that would result from further feeding of inflationary expectations. Some hardships are imposed on programs and people through restrictive fiscal and monetary policies. A recession ensues, although probably not more severe than in 1974-1975, but at least inflationary expectations and inflation itself would be reduced. Clearly, that was the intention of the measures recently announced by President Carter and Federal Reserve head Paul Volcker.

The choice is ours. We can allow inflation to get completely out of hand and try to deal with it then, or we can act now. It will be far less painful to cure a 15% inflation today than it will to cure a 25% inflation tomorrow.

With that as a backdrop, let me comment briefly on my personal reactions to the fiscal-monetary package unveiled last month which is a step, albeit a small one, in the right direction:

- The "bite" of the program is provided almost exclusively by monetary policy. Unfortunately, the fiscal portion of the package does not measure up.
  - -- There are no meaningful cuts in the 1980 non-defense budget; planned reductions will not become effective until 1981. That is a long time to wait. Fiscal 1980 will show a deficit of $40 billion plus.

-- The proposed $13 billion reduction for fiscal 1981 is too small a cut in Federal spending. One economist has calculated that this year's total Federal borrowing will account for over 23% of all credit raised, compared with less than 16% in 1974 and 2.5% in 1969. Government will increasingly crowd out private financing.

-- An increase in gasoline taxes, which may be desirable to encourage energy conservation and exploration, is recommended as a revenue-raising measure. This merely sidesteps the tough decisions needed to curb Federal expenditures. Instead, it shifts the burden of adjustment to the consumer. Inevitably, the share of Federal spending in the GNP will rise.

- Credit policy, therefore, will have to shoulder nearly the entire burden of reducing excess demands. That is regrettable. It means a reduction in business capital investment as well as in consumer spending. A tight monetary policy, unaided by adequate fiscal measures, can be extremely harmful to enterprise and investment and can further undermine productivity growth. That is just the sort of policy we must avoid.

Reconciling to the Longer Term

That brings me to the essential part of my testimony, namely, to reconcile sound longer-term capital formation policies with short-run actions to let steam out of our overheated economy. Too often we pay lip service to the long term while implementing politically

expedient short-run solutions. We need to think through how best to get to the "longer-run."

Our Declining Productivity

In January 1979, the New York Stock Exchange issued a report that analyzed the details of declining U. S. productivity growth in the 1970s. In the 15 months since then, the situation has seriously worsened. While productivity growth declined steadily from 3.1% during 1949-1969 to 1.6% during 1969-1978, the roof caved in in 1979! Productivity actually declined last year by almost a full percentage point. That was only the second time in the entire 34-year post-war period that the level of American productivity has actually dropped. The only other year in which that happened was 1974.

Just what does a productivity decline mean? In simple terms, it means that with production costs--labor and capital--remaining constant, we produce fewer goods and services. And when costs are spread over fewer goods, the average price of those goods rises as manufacturers pass cost increases along to customers. The result is accelerated inflation.

In a nutshell, that is how increased unit production costs--mainly labor costs--ratchet up inflation unless they are offset by productivity gains. In Chart 1 we can see the direct correlation between unit labor costs and inflation, as measured by the Consumer Price Index over the past 25 years; Chart 2 shows the role productivity gains play in offsetting wage increases and thereby checking rises in unit labor costs.

CHART I

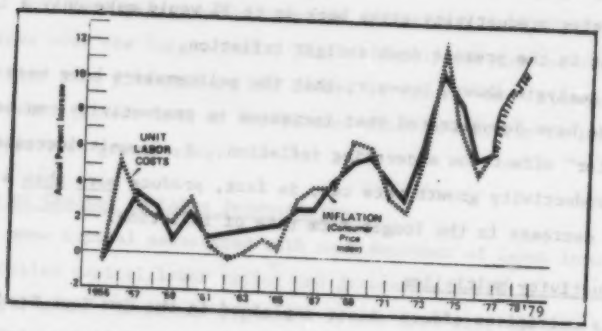
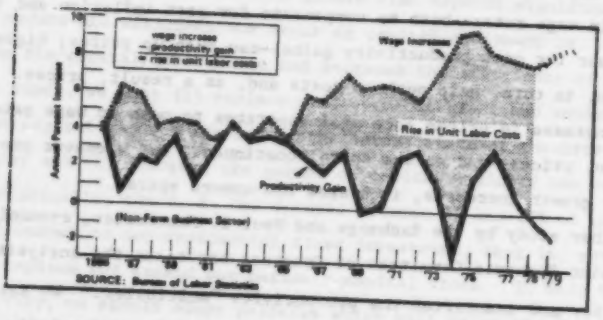


CHART II



U. S. policymakers have long understood that productivity in-
ences inflation in this way, but they have largely ignored the
ationship in the belief that productivity gains could have only
mall positive effect on inflation. They assumed that for every
-percentage-point gain in productivity, there would be only a

one-percentage-point decline in the rate of inflation. In that case, even boosting productivity gains back up to 3% would make only a small dent in the present double-digit inflation.

Our analysis shows, however, that the policymakers have been wrong. We have demonstrated that increases in productivity can have "multiplier" effects on moderating inflation. A one-unit increase in the productivity growth rate can, in fact, produce more than a one-unit decrease in the longer-term rate of inflation.

The Productivity Multiplier

This multiplier effect--first explained in the New York Stock Exchange's 1979 report, Reaching A Higher Standard of Living--interacts with the so-called "wage-price spiral," alluded to earlier. An increase in wage rates--both to compensate for past inflation and to reward labor for past productivity gains--can push up prices; higher prices can, in turn, help push up costs and, as a result, prices. The new increase in prices once again operates to push up wage rates and, again, prices--and so the spiral continues. But whenever productivity growth increases, it brakes the upward spiral.*

Further study by the Exchange and Paul B. Manchester, economist of the Joint Economic Committee of Congress has taken the analysis a step further and quantified the productivity "multiplier." We estimate that for every one-percentage-point increase in productivity, we can expect, on average, a 2.5-percentage-point decline in the long-run rate of inflation!** In other words, a gain of 3 percentage points

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* See Exhibit 1 for a description of the working of the multiplier.

** The multiplier works itself out over a period of years, reaching its full effect within five years. The full results of the multiplier analysis will be presented in a joint paper by Dr. Freund and Mr. Manchester at a conference of the American Productivity Center later this month

n the productivity growth rate--which would be less than the decline ecorded in recent years--would trim the inflation rate by 7.5 percen- age points over the longer term. That is hardly the type of reducti n inflation that policymakers can affor to ignore--and it demands hat we take a closer look at the factors which are likely to increase he productivity growth rate.

e Role of Capital in Labor Productivity

The more capital associated with each man-hour of labor input he so-called capital/labor ratio) the greater output will be. A n using a steam shovel can dig and displace more dirt per hour n if he used an ordinary garden spade and still more than if he ed only his hands. Productivity growth also depends significantly how modern and efficient our stock of capital equipment is. Thus, raise the capital/labor ratio and increase the efficiency of our ital stock, we must (1) replace old, worn-out plant and equipment h new capital goods which embody the latest state-of-the-arts hnology and (2) increase the amount of capital employed per worker.

Historically, the U. S. has devoted between 9% and 10% of our ional output to non-residential fixed investment, that is, money to replace and expand our nation's capital stock. To help boost uctivity, we should adopt policies which will raise the investment/ ratio by at least 2 percentage points--to at least 12%. This will dampen inflation and spur growth.

But increased capital spending is not the only way to stimulate uctivity. Neither is speeding up the assembly line. In fact,

If people become bored, or tired, or dissatisfied with working conditions, a faster assembly line may actually promote inefficiency and reduce, rather than increase, their output. Many other factors are involved. Productivity increases when:

- People are better trained
- People have better working environments
- People are in better health
- People have more and more efficient machinery and equipment to work with
- People develop new products and technology
- People move from less efficient to more efficient industries
- People manage their businesses more effectively

In short, productivity increases not only when people work harder--but when they work smarter.

Productivity and Economic Growth

From the end of World War II through the late 1960s, productivity increases in the United States accounted for almost 8/10 of each percentage point of output growth, while additional man-hours accounted for but 2/10. In the seventies, however, the proportion of output growth attributable to productivity declined substantially.

The following table shows how the output slowdown during the 1969-1979 period is directly related to the drop in productivity gains. The increase in man-hours merely prevented a more precipitous decline in output.

TABLE 1

Man-Hours, Productivity and Output

(Private Business Sector)

	Man-Hours		Productivity		Output
	--Average Annual Percent Increases--				
1949-1969	0.8%	+	3.1%	=	3.9%
1949-1959	0.5	+	3.2	=	3.7
1959-1969	1.2	+	2.9	=	4.1
1969-1979	1.6	+	1.3	=	2.9

Source: Bureau of Labor Statistics.

A major reason for the decline in productivity and output growth has been a decelerating increase in the capital/labor ratio. A rise in this ratio means that proportionately more capital than labor is being added to our economy and it implies that the amount of capital employed per worker is increasing; a decline in the ratio means the opposite. In 1976, this key capital/labor ratio stopped increasing for the first time in more than 20 years--and, in fact, fell slightly, as it did again in 1977 and 1978. It inched up a bit in 1979 but is still lower than it was in 1975.

A second major reason for declining productivity growth has been a decrease in the efficiency with which our economy has been able to convert capital investment into growth. In a study published last December, Building A Better Future: Economic Choices for the 1980s, the New York Stock Exchange introduced the Investment-Efficiency Ratio

IER, to help clarify the relationship between capital investment and real growth. The IER measures how much real growth the economy produces for each new investment dollar. The higher the real growth produced by each investment dollar, the higher the IER; the lower the real growth for each investment dollar, the lower the IER.

The IER enables us to measure the rate at which investment is converted into growth, with particular attention to whether that rate has been increasing or decreasing over the long term. In a sense, the IER is a "rate of return" for the economy as a whole. Just as the businessperson seeks profit returns on investment, so the economy, over all, seeks growth returns on investment. The IER measures the aggregate growth returns.

The concept can be summarized in the following simple equation:

$$\text{IER} = \frac{\text{Change in GNP*}}{\text{Capital Investment}}$$

The disturbing fact is that the IER has been declining over the long term--and the decline accelerated sharply in the 1970s. In effect, each new investment dollar now yields less real growth than in the past. The following table summarizes this decline by decade. For every dollar invested, the economy has produced:

- 30.2¢ of real growth from 1950-1959
- 27.1¢ of real growth from 1960-1969
- 12.8¢ of real growth from 1970-1979

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* As discussed in Building A Better Future, the change in GNP is the change attributable to capital investment, that is, GNP growth after deducting the effects of the increase in man-hourse worked.

Reasons for the Decline in the IER

Two significant developments have accompanied the IER decline.

- Regulation of the economy has increased--Regulation raises entrepreneurs' costs of pursuing potentially profitable business opportunities. Inevitably, in a highly regulated economy, entrepreneurs will forego many such opportunities. Excessive regulation also diverts capital to nonproductive uses. To be sure, regulation often produces such tangible benefits as cleaner air or water. But over-regulation can divert essential resources into activities which do little to improve output efficiency.
- Tax impediments to risk investment have increased--Higher tax rates through most of the 1970s, especially on capital gains, lowered after-tax returns on growth-oriented investments and increasingly stimulated consumption rather than risk-taking. Since new and existing growth companies were unable to attract funds, potentially high-growth ventures withered on the vine. Thus, Federal tax policy, however unintentionally, helped weaken investment efficiency.

International Comparisons

Rising productivity is essential to keep America competitive in international markets, since productivity gains make it easier to hold down the prices of goods we export. In recent years, however, our international competitors have been outselling us--mainly because their productivity gains have been higher than ours and because they have been saving and investing at much higher rates. Since 1960, for

example, the Japanese have funneled more than 30% of their GNP into fixed investment--compared with 14% in the U. S. This disparity is strongly reflected in the average annual rate of manufacturing productivity growth of nearly 9% in Japan--about four times the U. S. rate. In West Germany and France, the investment rates have been 25% and 22%, respectively--and annual manufacturing productivity growth exceeds 5 1/2% in both countries.

In 1960, the typical American worker in manufacturing annually produced as much as four Japanese workers or two French or German workers. Today, the American's output is matched by 1 1/2 Japanese and by 1 1/4 Germans or Frenchman. If this trend continues, all three will be outproducing us by the end of the decade.

* * *

Accelerated productivity gains mean more goods are produced. And more goods (greater output) mean lower prices. So we have a double stake in improving productivity. Unlike many policies that may promote either economic growth or price stability at the expense of the other, improving productivity growth helps achieve both goals. Productivity growth means more jobs, lower prices for consumers, greater efficiency and profits for business and, in the long run, greater revenues for the Federal government.

Conclusion

The critical question right now is how to reconcile short-run demand-oriented economic policies with longer-run supply-oriented investment incentives. After all, this hardly seems the time to cut investment taxes without a cut in Federal spending. But we cannot

continue to pay mere lip service to appropriate policies for the longer run. We cannot permit preoccupation with an endless succession of short-run priorities to foreclose our best chances to strengthen and improve the economy in the decade of the 1980s. It seems to me there are several courses of action possible now:

- Wherever possible, we should restructure tax policy to encourage investment without adding to the short-run budget deficit. This will require less government spending and perhaps even some offsetting tax increases.
- We should seize the opportunities inherent in any plans for a tax reduction in 1981 aimed at easing the widely expected recession to encourage the efficiency of production through capital investments. We should not use tax reductions as simply another dose of Keynesian demand stimulants leading to greater consumer and government spending. Tax incentives to capital formation and productivity should be used to remedy short-run demand shortfalls by stimulating the investment sector.
- We should begin now to reduce regulatory burdens which impede productive investment and entrepreneurial innovations.
- Policies in the private sector can also be adopted and encouraged to increase the productivity of men and women at work.

The key need now is to mesh our short and longer-run economic licies and objectives. It is easy to emphasize the here and now

and to give short-shrift to basic economic choices for the 1980s. I earnestly hope the Joint Economic Committee maintains its recent initiatives in building momentum behind policies to aid capital formation. Do not let the current inflation crisis deflect you from the realization that robust productivity growth is the essential ingredient for curbing inflation in the longer run and in producing new economic opportunities for growth, jobs, and real incomes in the years ahead.

EXHIBIT 1

THE MULTIPLIER MODEL

rgain

widely acknowledged that wage increases are generally
two main parts:*

increase to compensate labor for past inflation.
eed, with some two-thirds of negotiated wage con-
cts that cover 1,000 or more workers tied to cost-
living clauses, the adjustment to past inflation
ds to be built in. Moreover, contracts frequently
o reflect anticipated inflation over the contract
.

djustment for labor's entitlement to perceived
productivity gains. Workers expect their real
mes to rise and their real purchasing power to
ove. Since long-run improvements in real wage
s can only come from rising productivity, this
ent of the wage contract generally reflects
r's and management's perceptions about average
-run productivity gains.

rent observer of the economic scene commented on these
ts of current wage settlements: "...strong unions
ettle for nothing less than 3% (productivity offset)
e of inflation..."**

[large] unions all have contracts similar to the
neered by the auto workers in 1970--3% annual wage
plus essentially full adjustment for increases in
of living. When increases in the cost of fringe
are included, these contracts produce compensation
reases in real terms of 3% or slightly more per year.
se contracts were first negotiated, it was believed
l wage increases of about 3% were in line with the
s ability to provide higher real wages through pro-
y growth. In fact, however, the 3% figure was
ptimistic...since 1970 productivity has been only
year."***

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y, not all wage increases are set through formal col-
bargaining. Nonetheless, agreements reached in union
ions tend to have powerful spillover effects and set
for the entire labor market.

gama, "Economic Perspectives," Kidder, Peabody & Co.,
1978. However, few, if any, unions were able to
fset the 13.3 percent increase in the CPI in 1979.

aranty Survey, October 1978, pages 5-6.

The institutionalization of the long-outdated 3% productivity standard was remarked upon by Barry Bosworth when he was Director of the U. S. Council on Wage and Price Stability. He noted that:

> "...many labor contracts currently call for cost of living plus a productivity improvement. The only trouble is that this formula dates from the world of the 1950s and 1960s, when we had 3 percent annual productivity increases. This economy hasn't had a 3 percent annual productivity growth in a decade."*

Given this framework for wage negotiations, let us now review the process of accelerating inflation when productivity growth in one period slows down.

Accelerating Inflation

A slowdown in the productivity growth rate during one period will ignite an inflation speedup not only in that period but in succeeding periods--even after the decline in productivity growth is halted. This relationship can best be illustrated by means of an example.

Assume that in Period 1 workers anticipate no inflation because there was no inflation in the preceding year.** Labor seeks a wage increase of 3%, solely to match the perceived long-run average increase in productivity. In other words, workers expect their real incomes to rise and their purchasing power and standard of living to improve. If productivity actually rises by 3% in Period 1, the year will be inflation free.

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* A Conversation with the Honorable Barry Bosworth, American Enterprise Institute for Public Policy Research, 1978, page 29.

** Actually, the process could start from any base level of inflation.

riod 1

Assumed inflation	0%
Expected growth in real income	3%
Wage increase	3%
Productivity gain	3%
Actual inflation (unit labor costs)	0%

Next, assume that productivity gains slacken in Period 2, from per annum to 1½%--an assumption which conforms to the reality of ent years. The wage-price spiral is quickly activated:

iod 2

Assumed inflation	0%
Expected growth in real income	3%
Wage increase	3%
Productivity gain	1½%
Actual inflation (unit labor costs)	1½%

Workers anticipated that purchasing power would grow at the 3% rate as in Period 1. But because productivity dropped off, labor costs went up and so did prices. Hence, inflation enters picture at a rate of 1½%. In effect, wages increase by 3%, half hich is consumed by inflation, leaving only a 1½% increase in income. Labor is disappointed and readies new wage demands d at overcoming the real-income deficit.

Predictably, in Period 3, wage demands go up to 4½%. (The mption is reinforced by the large number of labor contracts have cost-of-living escalators built-in.)

Period 3

Assumed inflation	1½%
Expected growth in real income	3%
Wage increase	4½%
Productivity gain	1½%
Actual inflation (unit labor costs)	3%

Obviously, the windup of inflation is under way and will continue, as shown below, until something occurs to lower labor's wage demands or to raise productivity.

	Period			
	4	5	6	7
Assumed inflation	3%	4½%	6%	7½%
Expected growth in real income	3	3	3	3
Wage increase	6%	7½%	9%	10½%
Productivity gain	1½	1½	1½	1½
Actual inflation (unit labor costs)	4½%	6%	7½%	9%

In fact, inflation could spiral upward more rapidly than these calculations suggest, since labor may begin to anticipate future inflation and try to build it into wage settlements, thereby further fueling the inflation momentum.

Winding Down Inflation

Naturally, at some point labor will have to pare down its wage demands, say to 1½%, in response to the lower rate of productivity gains. Then, the rate of price increase will level off and the upward spiral of price rises will be broken. If that occurs in Period 8, the arithmetic would be as follows:

iod 8

Assumed inflation	9%
Expected growth in real income	1½%
Wage demand	10½%
Productivity gain	1½%
Actual inflation (unit labor costs)	9%

Inflation will decline below 9% only if productivity gains
lerate, say, back up to 3%.* Assume this happens and that,
least for a time, labor demands only a 1½% gain in real wages
match the previous plateau in productivity gains). The result
hat inflation begins to unwind.

	Period		
	9	10	11
med inflation	9%	7½%	6%
cted growth in real income	1½%	1½%	1½%
increase	10½%	9%	7½%
uctivity gain	3%	3%	3%
al inflation (unit labor costs)	7½%	6%	4½%

Now the process has been reversed, with the rise in producti-
causing inflation to decelerate from 7½% to 6% to 4½%. Infla-
will continue to wind down so long as the rate of productivity
continues to exceed labor's expected growth in real income.
those two factors come into balance--say, 3% productivity

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flation would also decline if labor agrees to accept something
s than assumed inflation plus a realistic allowance for pro-
ctivity growth.

growth and 3% expected growth in real income, inflation will stabilize at a constant rate until one of the key variables changes again.

A key question is the length of the adjustment periods; that is, how long does it take labor to adjust its wage demands to changes in productivity? Is labor able to argue for wage increases based on historic productivity changes or will labor base its real wage demands on relatively recent productivity performance? Whatever the answer, whatever the length of the adjustment period, productivity plays a key role in this entire process.

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